



# **INTERNATIONAL ECONOMICS**

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# Contents

## Part I. INTRODUCTION

1. The World Economy . . . . . 3  
A GLOBAL SURVEY, 4  
INTERNATIONAL TRADE AND NATIONAL SPECIALIZATION, 11  
A CHANGING WORLD, 19  
THE UNITED STATES IN THE WORLD ECONOMY, 21  
DOMESTIC POLITICS AND INTERNATIONAL TRADE, 25  
PROBLEMS, 28  
SELECTED REFERENCES, 29

## Part II. PRINCIPLES OF FOREIGN TRADE AND LENDING

2. A Brief Survey of Trade Theory . . . . . 33  
PLAN OF PRESENTATION, 33  
SINGLE COMMODITY TRADE, 34  
TWO COMMODITIES AND COMPARATIVE ADVANTAGE, 35  
PAYMENTS BALANCE AND EXCHANGE RATES, 37  
MANY COMMODITIES: WHICH ARE TRADED? 39  
CAPITAL TRANSFERS AND MERCHANDISE TRADE, 40  
NATIONAL INCOME AND THE TRADE BALANCE, 42  
MANY COUNTRIES AND MULTILATERAL TRADE, 43  
THE TERMS OF TRADE, 44  
CONCLUDING COMMENT, 45  
PROBLEMS, 46  
SELECTED REFERENCES, 46
3. Why Nations Specialize . . . . . 48  
CLIMATE, 48  
CONTRASTING FACTOR SUPPLIES, 51  
MINIMIZING TRANSPORTATION COST, 57

3. Why Nations Specialize (Cont.)

MISCELLANEOUS BASES OF GEOGRAPHIC SPECIALIZATION, 60

Mass-production economies, 60. Strength of the market, 60.

Economic symbiosis, 61.

CONCLUSIONS, 62

PROBLEMS, 63

SELECTED REFERENCES, 63

4. Factor Movements and International Trade . . . . . 65

THE EFFECT OF TRADE ON FACTOR REWARDS, 65

A complete trade embargo, 66. Free trade without transportation costs, 69. Partially obstructed trade, 74.

SOME EFFECTS OF LABOR MIGRATION ON TRADE, 74

INTERNATIONAL CAPITAL MOVEMENTS, 76

TRIANGULAR COMMODITY AND FACTOR MOVEMENTS, 77

CONCLUSIONS, 79

PROBLEMS, 79

SELECTED REFERENCES, 80

5. National Adjustments to a Changing World . . . . . 81

STRUCTURAL CHANGES AND MARKET PRICES, 82

EXCHANGE RATE ADJUSTMENTS, 83

The theory of adjustment via exchange rate variation, 84. Some special considerations, 87. Welfare aspects of currency depreciation, 89.

ADJUSTING TRANSFERS OF A COMMON MONEY, 91

A simple "common money" example, 91. Gold standard systems, 93. Gold "sterilization," 95.

GOVERNMENT MONETARY POLICIES, 96

INTEREST RATE ADJUSTMENTS, 96

NATIONAL INCOME AND INTERNATIONAL ADJUSTMENTS, 97

PROBLEMS, 100

SELECTED REFERENCES, 101

6. Controlled Disequilibrium . . . . . 102

GOALS AND MOTIVES OF GOVERNMENTS, 102

FULL EMPLOYMENT PROGRAMS, 104

Import restrictions, 105. Price ceilings and commodity rationing, 106. Currency depreciation unpopular, 108.

DISCRIMINATION AMONG IMPORTS, 110

## 6. Controlled Disequilibrium (Cont.)

SOME CONSEQUENCES FOR ECONOMIC THEORY, 112

### • PROBLEMS, 115

SELECTED REFERENCES, 116

## Part III. INTERNATIONAL PAYMENTS AND MONETARY PROBLEMS

## 7. The Balance of Payments Among Nations . . . . . 121

HOW CLAIMS AND COUNTER CLAIMS ARISE, 121

THE INTERNATIONAL ACCOUNTS OF THE UNITED STATES, 125

HOW WELL IS A NATION DOING IN THE WORLD? 129

Classifications of accounts, 129. Mature and immature debtors and creditors, 130. National wealth and international saving and investing, 132. Disequilibrium in the balance of payments, 133.

EXCHANGE CONTROL AND ARTIFICIAL EQUILIBRIUM, 136

PROBLEMS, 138

SELECTED REFERENCES, 139

## 8. Making International Payments . . . . . 140

THE MEANING OF FOREIGN EXCHANGE, 140

FINANCIAL PAYMENTS, 141

•Purchase of a foreign bank draft, 141. Sale of foreign claims to a domestic bank, 142.

PAYING FOR MERCHANDISE, 143

The documented bill of exchange, 143. The import letter of credit, 145. The export letter of credit, 146. Domestic purchase of a foreign trade bill or bank draft, 149. Settlement through a third currency, 150.

EXTRAORDINARY GOLD TRANSFERS, 150

HOW IMPORTS HELP TO FINANCE EXPORTS, 151

PROBLEMS, 153

SELECTED REFERENCES, 154

## 9. The Rate of Exchange . . . . . 155

A STRUCTURE OF EXCHANGE RATES, 155

INCONVERTIBLE PAPER CURRENCIES, 157

The foreign exchange market, 157. The purchasing power parity concept, 159. Triangular currency arbitrage, 160. Forward exchange, 162.

SEMI-GOLD CURRENCIES, 163

**9. The Rate of Exchange (Cont.)**

GOLD STANDARD CURRENCIES, 164

GOVERNMENT INTERVENTION AND EXCHANGE RATES, 165

How stabilization funds operate, 166. Exchange-control principles, 168. Disorderly cross rates, 169.

PROBLEMS, 170

SELECTED REFERENCES, 170

**10. Controls to Conserve Foreign Exchange . . . . . 172**

EXCHANGE CONTROL, 172

Exchange control and import licensing, 173. The purposes of exchange control, 173.

COST VERSUS QUANTITATIVE RESTRICTIONS, 174

The control of payments, 175. The control of receipts, 176. Controlling capital movements, 177.

TRADE AND PAYMENTS AGREEMENTS, 178

The bilateral trade-quota accord, 178. Bilateral payments agreements: their nature, 179. Operational and other characteristics, 180.

EXCHANGE CONTROL ILLUSTRATED: HIGHLIGHTS OF THE STERLING SYSTEM, 183

PROBLEMS, 185

SELECTED REFERENCES, 185

**11. Mechanisms to Promote Stability and Freedom of the Exchanges . . . . . 187**

THE STERLING AREA SYSTEM, 187

Prewar arrangements, 189. The wartime system, 190. The postwar sterling accounts, 193. Transferability and convertibility, 193.

THE EUROPEAN PAYMENTS UNION, 195

Antecedents, 195. Nature of the EPU, 200. Settlement of net balances, 201. Scope of the EPU system, 203. The EPU and trade liberalization, 204. The EPU and wide convertibility, 204. A summing up of EPU and EMA, 209. EMA and the tripartite monetary agreement, 210.

THE INTERNATIONAL MONETARY FUND, 210

Organization, 211. Operations, 211. Everlastingly transitional? 213. The scarce currency clause, 214. Other activities, 214.

A SUMMARY STATEMENT REGARDING UNITED STATES INTERNATIONAL MONETARY POLICIES, 215

PROBLEMS, 217

SELECTED REFERENCES, 218

**Part IV. ECONOMIC NATIONALISM TODAY**

<b>12. Protection</b>	<b>223</b>
• <b>PROTECTION TAKES MANY DIFFERENT FORMS, 223</b>	
Import duties, 224. Quotas, 226. Embargoes, 226. Exchange control, 226. Government purchasing preferences, 228. Subsidies to home producers, 229. Compulsory "marks of origin," 230. Enforcement of trade-mark laws against imports, 230. Excessive valuation of imports, 231. Unnecessary inconvenience in clearing customs, 231. Meticulous application of tariff classifications, 232. "Dumping" duties and "escape" clauses, 232.	
<b>LABOR UNION ACTIONS AGAINST IMPORTS, 234</b>	
<b>WHO IS FOR AND AGAINST PROTECTION? 235</b>	
<b>ECONOMIC ARGUMENTS AGAINST PROTECTION, 237</b>	
It prevents trade which is generally beneficial, 237. It preserves inefficiency, 239. It limits the consumers' choice of goods, 240.	
<b>SOCIAL ARGUMENTS AGAINST PROTECTION, 240</b>	
Corrupt domestic government, 240. Disrupts national unity, 241. Embitters international relations, 242.	
<b>WHY IS PROTECTION SO EXTENSIVE? 243</b>	
<b>PROBLEMS, 246</b>	
<b>SELECTED REFERENCES, 246</b>	
<b>13. Tariffs and Quotas</b>	<b>248</b>
<b>THE CUSTOMS AREA, 248</b>	
<b>KINDS OF TARIFFS, 250</b>	
<b>VALUATION OF IMPORTS, 252</b>	
<b>KINDS OF QUOTAS, 259</b>	
Tariff quotas, 259. Unilateral import quotas, 260. Licensing of imports, 262. Bilateral quotas, 263. Mixing quotas, 264.	
<b>THE INCIDENCE OF TARIFFS AND QUOTAS, 264</b>	
<b>SOME TARIFF AND QUOTA COMPARISONS, 268</b>	
<b>PROBLEMS, 269</b>	
<b>SELECTED REFERENCES, 270</b>	
<b>14. Subsidization of Shipping</b>	<b>271</b>
<b>WHAT COUNTRIES DEPEND ON SHIPPING INCOME? 271</b>	
<b>WORLD SHIPPING STATISTICS, 274</b>	
<b>AMERICAN SHIPPING AND ITS SUPPORTERS, 280</b>	
<b>FEDERAL MARITIME POLICY, 282</b>	
Shipbuilding subsidies, 283. Operating subsidies, 285. Navigation acts and cargo preferences, 287.	



**14. Subsidization of Shipping (Cont.)**

NATIONAL DEFENSE OR JUST MERCANTILISM? 289

CONCLUDING COMMENT, 292

PROBLEMS, 293

SELECTED REFERENCES, 293

**15. Pleas for Protection . . . . . 295**

KEEP THE GOODS AND MONEY, 295

INCREASED OUTPUT AND EMPLOYMENT, 296

EXCLUDE FOREIGN DEPRESSIONS, 297

REAR INFANT INDUSTRIES, 299

SAFEGUARD DOMESTIC WAGES, 301

PROTECT DOMESTIC PROGRAMS, 304

EQUALIZE COSTS OF PRODUCTION, 306

BARGAIN WITH TARIFFS AND QUOTAS, 307

NATIONAL DEFENSE, 308

CONCLUDING COMMENTS, 311

PROBLEMS, 312

SELECTED REFERENCES, 312

**16. Immigration . . . . . 313**

TEMPORARY LABOR MIGRATION, 313

EMIGRATION OF ITALIANS: A CASE STUDY, 316

PERMANENT IMMIGRATION AND ECONOMIC DEVELOPMENT, 320

UNITED STATES IMMIGRATION POLICY, 323

POPULATION PRESSURE AND OPTIMUM SIZE, 329

PROBLEMS, 334

SELECTED REFERENCES, 334

**Part V. COMMERCIAL POLICY****17. United States Commercial Policy . . . . . 337**

TO SEE OR NOT TO SEE IN PERSPECTIVE, 337

HISTORICAL SKETCH OF THE AMERICAN TARIFF, 339

TRADE DISCRIMINATION, 342

A brief history of the most-favored-nation clause, 342. Exceptions to American anti-discrimination policy, 346. Discrimination to prevent the contraction of trade? 347.

THE IMPORTANCE OF IMPORTS, 350

**17. United States Commercial Policy (Cont.)**

**THE TRADE AGREEMENTS PROGRAM, 353**

- Main features, 353. Early postwar legislation, 356. The hat case, 359. Spring clothespins, 359. Hatters' fur, 360. Garlic, 360. The GATT, 360. The Trade Agreements Extension Act of 1955, 361.

**PROBLEMS, 363**

**SELECTED REFERENCES, 365**

**18. The GATT . . . . . 366**

**HISTORY OF THE GATT, 366**

**STRUCTURE, 368**

**THE ARTICLES OF THE GATT, 369**

**THE ORGANIZATION FOR TRADE COOPERATION, 376**

**THE WAIVER ISSUE, 378**

**TREATMENT OF JAPAN, 380**

**POSTSCRIPT ON QRs, 380**

**PROBLEMS, 381**

**SELECTED REFERENCES, 383**

**19. Reactionary Dangers in Our Commercial Policy . . . . . 384**

**AGRICULTURAL POLITICS AND TRADE POLICY, 384**

- Parity, 385. Price supports and surpluses, 385. International aspects—introduction, 386. Methods of foreign surplus disposal, 387. Foreign effects of the disposal program, 388.

**THE ESCAPE CLAUSE, 391**

- Importance of the injury issue, 391. The role of the Tariff Commission, 392. The role of the President, 397. A summing up, 397. The escape clause and the future, 398.

**ANTI-DUMPING ACTIONS, 399**

- Kinds of dumping, 400. Restrictive effects, 401. The Castiron Soil Pipe Case, 402.

**PROBLEMS, 403**

**SELECTED REFERENCES, 404**

**20. Western European Regionalism . . . . . 405**

**THE ORIGINS, 405**

**THE MARSHALL PLAN, 407**

**HIGHLIGHTS OF THE OEEC, 409**

- The Annual Review, 410. NATO and economics, 411.

**THE COAL AND STEEL COMMUNITY: "SUPRANATIONAL" 414**

- Objective, 414. Key institutions, 415. The common 416. Development powers, 417. Cartels, 418. Accomplishments, 419.

- 20. Western European Regionalism (Cont.)**  
 A EUROPEAN FREE TRADE AREA, 420  
 PROBLEMS, 422  
 SELECTED REFERENCES, 423
- 21. State Trading . . . . . 425**  
 THE SOVIET FOREIGN TRADE MONOPOLY: ITS STRUCTURE, 425  
     Historical sketch of Soviet foreign trade, 427. Soviet state trading  
     and nondiscriminatory treatment, 428.  
 USING TRADE FOR NUISANCE-MAKING OR WORSE, 430  
 WESTERN EUROPEAN STATE TRADING, 433  
 AMERICAN STATE TRADING, 434  
 ECONOMIC COEXISTENCE, 435  
 INTERNATIONAL AGREEMENTS RESPECTING STATE TRADING, 438  
 PROBLEMS, 439  
 SELECTED REFERENCES, 441
- 22. International Commodity Agreements . . . . . 442**  
 THE INTERNATIONAL WHEAT AGREEMENT, 443  
     Working of the agreement, 444. Weaknesses in the agreement,  
     447. Britain's rejection, 450. Appropriate objectives, 451.  
 PROBLEMS, 453  
 SELECTED REFERENCES, 454

## **Part VI. ECONOMIC DEVELOPMENT AND INVESTMENT**

- 23. The General Problem of Economic Development . . . . 459**  
 AN ATTEMPT AT DEFINITION, 460  
 WHY ARE SOME COUNTRIES UNDERDEVELOPED? 464  
     Resources: a preliminary comment, 466. The people, 467. Re-  
     gional aspects, 469. Something on institutions, 470. The popula-  
     tion question, 472. Government and the people, 474. Saving and  
     capital formation, 476.  
 SOME COMMON MISCONCEPTIONS, 477  
     Planning and the market economy, 477. Development and  
     "needs," 478. Cheating via the terms of trade? 479. Controlling  
     imports to promote development, 480. Disguised unemployment,  
     481. Operation rooftop, 482. Illiquidity of asset structure? 483.  
     What is the case for inflation? 484. How not to measure the con-  
     tribution of foreign capital to economic development, 487.  
 PROBLEMS, 488  
 SELECTED REFERENCES, 490

## CONTENTS

xvii

<b>24. Domestic Policies of Developing Economies . . . . .</b>	<b>492</b>
INDUCED VERSUS SPONTANEOUS GROWTH, 492	
INVESTMENT CRITERIA, 494	
Social marginal productivity, 494. Some qualifications, 495. The upshot, 496.	
SOCIAL OVERHEAD CAPITAL, 497	
A critical minimum effort? 498. The pre-conditions, 500. Where's the money coming from? 502. The capital-output ratio, 504.	
ACTION IN THE PRIVATE SECTOR, 506	
Agriculture versus industry, 506. Programs in agriculture, 507. Industrialization, 509.	
PROBLEMS, 513	
SELECTED REFERENCES, 515	
<b>25. Development and International Investment . . . . .</b>	<b>517</b>
THE GENERAL PANORAMA OF AMERICAN FOREIGN INVESTMENT, 518	
TECHNICAL ASSISTANCE, 519	
Magnitudes, 522. Regionalism: the Colombo Plan, 522. National interest and technical assistance, 524.	
LARGE-SCALE AID FOR DEVELOPMENT, 527	
AN IMAGINATIVE WAY: USING FARM SURPLUSES TO FINANCE DEVELOPMENT, 531	
THE WORLD BANK, 532	
Structure and organization, 533. Loans and guarantees, 535. How loans are made, 537. The influence of the Bank, 539.	
THE INTERNATIONAL FINANCE CORPORATION, 540	
THE EXPORT-IMPORT BANK, 542	
SOME PROBLEMS OF FOREIGN INVESTMENT, 544	
The nineteenth century, 544. Capital receipts and investment service, 546. Self-sustained growth, 547. The problem of repayment, 548.	
PROBLEMS, 549	
SELECTED REFERENCES, 550	

## APPENDICES

<b>A. The Pure Theory of International Equilibrium . . . . .</b>	<b>555</b>
CONDITIONS OF EQUILIBRIUM, 555	
NATIONAL INCOME AND THE FOREIGN BALANCE, 556	
Injections and leakages, 556. National income determination, 557. Some effects of changing propensities, 560.	

<b>A. The Pure Theory of International Equilibrium (Cont.)</b>	
DOMESTIC ACCUMULATION SCHEDULE, 561	
THE EXCHANGE RATE AND NATIONAL INCOME, 563	
INCOMPATIBLE LENDING RATES, 565	
CONCLUSIONS, 568	
<b>B. Mercantile and Classical Theories of International Trade</b>	<b>569</b>
MERCANTILIST VIEWS, 570	
DAVID HUME AND THE INTERNATIONAL DISTRIBUTION OF SPECIE AND BULLION, 572	
ADAM SMITH'S ARGUMENTS FOR FREER TRADE, 573	
DAVID RICARDO AND THE PRINCIPLE OF COMPARATIVE ADVANTAGE, 576	
JOHN STUART MILL AND THE EQUATION OF INTERNATIONAL DEMAND, 578	
NASSAU SENIOR AND INTERNATIONAL WAGE COMPARISONS, 581	
THE REFORMULATED CLASSICAL THEORY OF INTERNATIONAL TRADE, 581	
CRITICISMS OF THE CLASSICAL THEORIES, 585	
<b>C. The Machinery of Policy-Making in Washington</b>	<b>587</b>
REPORTS FROM THE FIELD, 587	
WASHINGTON AT THE TECHNICIANS' LEVEL, 589	
POLICY-MAKING AT THE DEPARTMENTAL LEVEL, 592	
Top inter-departmental committees, 593. Other activities at the departmental level, 595.	
THE WHITE HOUSE, 595	

**PART I**

**INTRODUCTION**



## CHAPTER 1

# The World Economy

The status of the United States in the world today, both as a member of many international agencies and in its position of leadership, is such that few Americans can afford to ignore the impact of world affairs on their future taxes, alliances, and security. The importance of international economics is that it provides both a tool of analysis and a body of information that help one understand significant aspects of world affairs. For example, the commercial policies of the United States weaken or strengthen certain of our military alliances, and our own security is ultimately linked to the economic welfare and political stability of many underdeveloped areas of the world. Also, quite apart from cold war considerations, it is often not recognized how closely related are prosperity in the United States and abroad. Our economy depends on a variety of raw material imports, we import more when we are prosperous, and our payments for these imports permit foreign nations to buy our exports. The foreign loans and investments of our government, banks, and businesses depend on events and prospects abroad, and these financial policies in turn influence merchandise trade between the United States and the rest of the world. Government grants in aid, usually made in response to political dangers abroad, have a similar trade impact. Most of these developments, together with the evolution of American commercial policy, have a marked incidence on special interest groups in the United States which are organized to influence public opinion and are often represented in Washington. That is one reason why



## INTRODUCTION

free trade, which in general would be the most beneficial policy for the United States, only exists for a limited number of goods. Because of all these circumstances, it is almost impossible to consider international economics apart from foreign policy and domestic politics.

## A GLOBAL SURVEY

It is intriguing to imagine what a Martian visitor might report about Earth, and its international economic life, on his return home. We can be certain that he would mention the great differences in population pressure and consumer well-being among countries, the comparative lack of economic intercourse between the Soviet bloc countries and the rest of the world, and the restriction of immigration by "colored" peoples into the lands of more recent settlement. The visitor from Mars would probably also be struck by our specialization in production, which results in a few nations producing most of the world's supply of certain commodities. Whether he would be surprised to learn how many governments will not permit their nationals to own or freely buy foreign currencies we cannot say. And knowing nothing of the world's history during the past half century he could hardly describe the many changes in the world's economic structure that have occurred during this period. So in certain areas we will have to supplement his imaginary report.

Statistics are a dry but useful way to describe the differences in economic welfare existing between countries. One way is to compare death rates, especially those of infants. Another is to compare per capita food consumption, housing facilities, and ownership of durable consumer goods.

Infant mortality rates tend to be inversely proportional to consumer welfare. These rates are very high in a country like Egypt (129 a year per thousand population) and low in a country like Sweden (19). Table 1.1 gives infant mortality rates for twenty-three selected countries, together with crude birth and death rates, and population density. The crude death rates tend to be

high in countries having a high population density, although Sweden and Holland are exceptions: moreover, a few countries, for example Mexico, have high death rates despite a low population density. The explanation is that Sweden and Holland are able to maintain a high level of consumption, through specialized production and international trade, while Mexico is unable to do so. The United Kingdom is another familiar example of a country maintaining a high population density at a relatively high standard of living through international trade.

A constant threat to human well-being is population growth that outstrips productive resources. A comparison of the crude birth and death rates in Table 1.1 indicates that all the countries listed are experiencing a natural population increase. This is over 2.0 per cent a year in the case of Egypt and Mexico. It is about 1.5 per cent a year in the case of Argentina, Canada, Japan, New Zealand, Poland, and the United States, to mention a few countries.

Now the population of a country will double every 35 years at a 2 per cent compound increase rate, and every 50 years at a 1.5 per cent compound increase rate. If the world's population continues to grow at present rates, there will be standing room only in another thousand years. In the past few centuries human inventiveness and the development of new lands have more than kept ahead of this population "explosion"; and technological advances will continue to increase the productivity of each worker, providing he has natural resources and capital equipment with which to work. None the less, a great challenge confronts mankind, especially in countries like Egypt, India, and Japan: the population increases of the next half century provide a grim prospect. (Part VI is directed partly towards this problem.)

Reverting to the circumstances of today, and the differences in economic well-being that currently exist among nations, Table 1.2 is significant. Among other things, it shows differences in food intake. We can note that the daily calorie intake per capita is about twice as much in Australia, say, as in India: it is also worth noting that the diet in such countries as Egypt, Japan, and Italy is essentially one of starch, with only a few countries, such as

TABLE 1.1

POPULATION PRESSURE WITH BIRTH AND DEATH RATES FOR SELECTED COUNTRIES

Country	Population Density per sq. Kilometer <sup>a</sup>	Crude Birth Rate <sup>b</sup>	Crude Death Rate <sup>c</sup>	Infant Mortality Rate <sup>d</sup>
Argentina	6.5	24.6	8.7	65.2
Australia	1.1	22.9	9.1	23.3
Belgium	288	16.7	11.9	44.8
Canada	1.5	27.9	8.6	35.9
Cuba	51	20.6	10.8	98.8
Denmark	102	17.9	9.0	27.2
Egypt	22	44.7	19.3	128.6
France	78	18.7	12.9	37.8
Germany, West	200	15.5	11.0	46.3
India	113	24.8	13.6	116.3
Italy	159	17.2	9.8	58.9
Japan	235	21.5	8.9	49.4
Mexico	14	44.6	15.6	94.5
Netherlands	324	21.8	7.7	22.1
New Zealand	8	25.4	9.0	25.9
Norway	10	18.8	8.3	23.7
Poland	85	30.5	11.6	107.8
Sweden	16	15.4	9.7	18.7
Switzerland	118	17.0	10.2	29.8
U. of S. Africa	11	25.7	8.9	34.1
United Kingdom	208	15.9	11.4	27.5
United States	20	24.7	9.6	27.9
Yugoslavia	66	28.3	12.4	116.5
<i>Median</i>	<i>66</i>	<i>21.8</i>	<i>9.7</i>	<i>37.8</i>

<sup>a</sup> For 1953. Per square mile population is about 2.6 times as great.<sup>b</sup> Number of live births per 1,000 population in 1953.<sup>c</sup> Number of deaths, excluding still births, per 1,000 population in 1953.<sup>d</sup> Number of deaths under 1 year of age, excluding still births, per 1,000 population under 1 year of age in 1953.SOURCE: United Nations, *Statistical Year Book*, 1953.

Canada and New Zealand, enjoying diets of more than one-third animal origin.

There are also marked differences in the quantity and quality of shelter available to families in various countries. Although families in the United States are relatively small, it has a high percentage of dwelling units having more than two rooms. Another criterion of shelter adequacy is the percentage of homes

equipped with electricity: although this is partly a function of urban living, it is enlightening to compare France with Germany, or Argentina with Australia.

Ownership of automobiles is often associated with a high standard of living; it is also related to poverty of public transportation and scattered population. Table 1.2 indicates that the ownership of passenger cars per 1,000 of population is about seven hundred times as great in the United States as in India and about one hundred and seventy times as great in Canada as in Japan. The use of commercial vehicles per 1,000 population is a crude indi-

TABLE 1.2

SOME COMPARISONS OF CONSUMER WELL-BEING FOR SELECTED COUNTRIES

Country	Food		Shelter		Transportation	
	Daily Calories per Capita	Percentage Calories of Animal Origin	Percentage Dwelling Units Having 2 or More Rooms	Percentage Dwelling Units with Electricity	Passenger Cars per 1,000 Population	Commercial Vehicles per 1,000 Population
Argentina	3,110	34	37.3	59.7	17	13
Australia	3,290	38	92.7	81.5	132	66
Belgium	2,950	33	74.5	95.3	36	17
Canada	3,130	42	93.3	87.0	170	59
Cuba	2,730	21	—	—	18	7
Denmark	3,250	36	93.1	99.2	30	17
Egypt	2,360	8	44.2	—	3	1
France	2,850	28	49.3	89.0	47	29
Germany, West	2,840	33	86.5	98.4	22	17
India	1,590	7	—	—	<sup>4</sup>	<sup>3</sup>
Italy	2,580	15	—	—	13	6
Japan	2,210	4	—	—	1	2
Netherlands	2,890	28	89.6	92.4	18	9
New Zealand	3,340	49	94.0	92.6	156	53
Norway	3,120	40	73.0	82.9	27	23
Sweden	3,000	42	—	—	60	15
Switzerland	3,110	33	77.7	99.9	43	10
United Kingdom	3,060	35	93.0	—	55	21
United States	3,120	40	89.6	94.3	288	58
Median	3,000	33	89.6	92.5	30	17

SOURCE: United Nations, *Statistical Year Book*, 1954.

cation both of mechanization in production and general economic welfare: thus it is noteworthy that the commercial vehicle rate is high in areas of recent settlement (such as Australasia) as compared with the older economies of Europe (such as Belgium).

An examination of other statistics would tend to confirm what has already been stated. Most people know in a general way that the United States is a "rich" country and India is a "poor" one, although they probably do not realize how great these differences are, or the comparative circumstances of the other countries included in the tables. And still fewer people have really examined the causes of these differences in consumer well-being.

Some of these differences are probably due to intangible things that cannot be expressed statistically but should be mentioned briefly. A puritan heritage may influence people to produce more even though they may laugh less. Countries having child marriages will tend to have high birth rates and dense populations. Workers in poor lands are often debilitated from malnutrition and disease. People who understand the value and use of capital facilities are more likely to save part of their incomes and invest wisely. There are many sociological factors that explain some of the differences in the material welfare of, say, the average Swede and Italian.

There is a more tangible explanation. If each worker in an economy has the use of extensive natural resources and expensive capital equipment, each worker will produce more per day of labor, and his country will have a higher per capita income. Families having high incomes can save more for investment in productive facilities. Accordingly, any comparative analysis of national economies must include an examination of real investment rates and the availability of productive aids per worker.

There is no need to introduce here extensive data on national differences in endowment per worker. This aspect of the matter is considered in detail in Chapter 3. However, a few contrasts can be pointed out. The United States provides an outstanding example of a country where labor is combined with many productive resources: thus, on an average, each worker has the use of

19 acres of agricultural land, 3.7 "units" of real or fixed capital, and the energy equivalent of 21.1 metric tons of coal a year. In a country like Italy, however, each worker has the average use of only 2.6 acres of agricultural land, 1.2 units of capital, and the energy equivalent of 1.9 metric tons of coal. Some countries are particularly long on agricultural land; thus Australia has 288 acres per worker. Some are short on land but fairly long on other factors of production: thus the United Kingdom has only 2.1 acres of agricultural land, but an energy equivalent of 10.4 tons of coal, per worker. The first table and chart in Chapter 3 systematically presents these differences.

Countries also differ in their ability and willingness to devote annual production not to consumption but to investment. Nations that add to their stock of productive facilities—whether privately or publicly owned—are better able to expand production. Table 1.3 shows that a few countries such as Australia and Denmark are devoting almost one-fourth of their annual output to fixed capital replacements and additions. The corresponding figure for, say, Greece or Ireland is two fifths lower. A lamentable feature of the postwar period has been the low rate of gross capital accumulation in the United Kingdom—an approximate 14 per cent—which barely suffices to replace worn out facilities. If this continues for another decade, the productivity of the British worker will fall behind that of such continental countries as Belgium, the Netherlands, and Germany.

An outstanding feature of the world economy today is that the Soviet bloc of nations is largely isolated from the world's trade. Only about two per cent of the total value of all international merchandise trade consists of trade between the Soviet Union, the satellite countries and China on the one hand and the rest of the world on the other. As regards international economics, as in other matters, the Soviet bloc is a world apart.

Another fact that would strike a visitor to Earth—a fact so familiar to us that we overlook it—is that the populations of many of the most densely inhabited areas are not permitted to migrate to those lands possessing many natural resources that yield high

TABLE 1.3  
PERCENTAGE EXPENDITURES ON GROSS DOMESTIC PRODUCT, 1954

Country	Monetary Unit	Gross Domestic Product (m. = millions; b. = billions)	Consumption		Fixed Capital Formation (gross)	Income in Stocks	Exports	Imports
			Private	Govt.				
Australia	Aust. pounds	4,832 m.	65	9	26	3	18	-21
Austria	schilling	88 b.	67	13	21	-3	2 <sup>a</sup>	-3
Burma	kyats	4,583 m.	67	14	18	4		-21
Canada	dollars	24 b.	65	14	22	-1	21	-12
Chile <sup>b</sup>	pesos	234 b.	77	13	9	-1	14	-32
Denmark	kroner	30 b.	67	12	23		30	-15
France	francs	15,395 b.	67	16	17	1	14	-18
Germany, West	marks	146 b.	56	16	21	3	22	-19
Greece	drachmas	54 b.	82	13	14	-1	11	-37
Ireland <sup>c</sup>	pounds	484 m.	79	13	14	1	30	-13
Italy	lire	12,338 b.	71	11	20	-1	11	-11
Japan	yen	7,353 b.	63	11	21	3	13	-50
Netherlands	guilders	25,660 m.	61	17	19	4	49	-22
Portugal	escudos	49 b.	78	11	14	1	18	-22
Sweden	kroner	42 b.	63	17	21	-1	22	-20
United Kingdom	pounds	17,435 m.	67	18	14	1	20	-5
United States <sup>d</sup>	dollars	359 b.	66		36	-1	4	

<sup>a</sup> Net trade value.

<sup>b</sup> 1952.

<sup>c</sup> 1953.

<sup>d</sup> "Gift" exports treated as consumption.

SOURCE: United Nations, *Monthly Bulletin of Statistics*, December, 1955.

returns to the labor that works them. The principal reason behind this prohibition is not economic but racial. The "new" countries that are relatively "empty"—such as Australia, Canada, Argentina, and the United States—are governed by white people. The countries that suffer the worst population pressures—such as Japan, India, and Egypt—are populated by people of a different culture and appearance. Actually the world probably does not now possess the extra transportation facilities that would be required annually to move the natural population increase out of these densely popu-

lated countries. Nevertheless it is not surprising that agitators in these countries can inflame people against countries like the United States. Their agitation is often effective because the densely populated countries are poor and the "white" countries of the new world are rich.

The problem is further complicated in that such countries as India and Japan are of some strategic importance to the free-world alliance. Neither Washington nor London, for example, wishes to see these lands fall under Soviet influence. Thus the "cold war" is fast becoming an economic struggle and a race against time. The United States is seeking to speed the development of the less developed economies, the United Kingdom has advanced the dates at which various parts of the Empire will attain self-government, and the Soviet Union is attempting to thwart these efforts by organizing resentment against the Americans and British. And all the while the populations of these less developed economies are growing at a rate that may depress living conditions in them still further: the human urge to reproduce is, in these countries, on the side of the Soviet Union.

### INTERNATIONAL TRADE AND NATIONAL SPECIALIZATION

Although international migration on a large scale is impracticable—and not only because of legal restrictions—nations can improve their economic situations by exchanging goods and services. This is obviously true of densely populated countries that can export labor intensive goods in exchange for food and other imports that are land intensive. International trade can also give advantages to economies that have a high ratio of land or capital to labor, for they can import labor intensive goods in exchange for those that are land intensive or capital intensive. Thus Australia exports wool, meat, and wheat in exchange for factory-made goods from Britain and a few handicrafts from the Far East. Similarly it is uneconomic for the United States to produce labor intensive items (such as lace or hand tooled leather) when that same labor could be combined with land (raising beef perhaps)



or with capital (assembling cash registers for instance). It is not that American labor cannot make handicraft items but that it is more economical for the United States to specialize in making those things in which it has a *comparative* advantage.

Usually countries that have a very unbalanced endowment of productive factors can obtain more benefits from international trade, getting, as it were, through trade, the use of foreign production factors that are domestically in short supply. There is also a tendency, other things being equal, for rich countries to trade more than poor countries. Poorer countries have less to export that others want. Also consumption is more varied in richer countries, so that all sorts of exotic items are in demand that are not domestically produced.

Table 1.3 shows that some countries make more use of international trade than do others. Thus, in value terms, the Netherlands export about one half of what they produce and import about one half of what they use at home. Corresponding figures for Canada are about one fifth. By way of contrast the United States—excluding foreign aid gifts—imports and exports only about one twentieth of its gross domestic product: this is partly because American labor is very adequately combined with *both* natural resources and capital equipment, but also because the United States economy is less specialized than it would be in the absence of government “protection” and “support” programs.

The importance of international trade to different national economies can also be shown after the manner of Table 1.4. This indicates the value of imports per capita and the value of exports per worker for various countries. Imports per capita give a rough idea of the importance of foreign goods in domestic use while exports per worker indicate the significance of foreign markets for the home labor force. It is apparent that the Scandinavian countries and the Low Countries are, considering their population sizes, very active in foreign trade. So are the “white” British dominions. Thus the value of New Zealand’s exports amounts to almost a thousand dollars a year per actively engaged person. Corresponding figures for the United States and the Soviet Union are 250

dollars and 3 dollars respectively. Actually Table 1.4 understates the importance of foreign trade for some of these countries because it relates only to merchandise trade and does not include the sale of services: for example, Norway earns almost as much from its shipping as it does from its merchandise exports.

TABLE 1.4  
COMPARATIVE IMPORTANCE OF MERCHANDISE TRADE TO THE ECONOMIES OF  
SELECTED NATIONS

Country	Total Popu- lation <sup>a</sup> (millions)	Economi- cally Active Popu- lation <sup>b</sup> (millions)	Mer- chandise Imports <sup>c</sup> (millions)	Mer- chandise Exports <sup>d</sup> (millions)	Imports per Capita	Exports per Worker
Australia	8.8	3.2	\$ 1,685	\$ 1,692	\$193	\$523
Belgium	8.8	3.5	2,550	2,303	290	665
Brazil	55.8	17.1	1,633	1,562	29	91
Canada	14.8	5.3	4,204	3,986	285	750
Denmark	4.4	2.1	1,162	948	264	451
Egypt	21.9	6.7	459	397	21	59
France	42.9	20.5	4,348	4,321	101	210
Germany, West	49.0	22.1	4,601	5,264	96	239
India	372.0	101.8	1,229	1,169	3	10
Italy	48.1	21.3	2,387	1,634	48	76
Japan	86.7	36.3	2,399	1,629	28	45
Netherlands	10.5	3.9	2,852	2,413	272	618
New Zealand	2.0	.7	597	684	298	975
Norway	3.4	1.4	1,019	583	300	416
Sweden	7.2	3.1	1,777	1,588	247	512
Switzerland	4.9	2.2	1,304	1,230	266	559
U. of S. Africa	13.1	5.3	1,242	901	95	170
U.S.S.R.	207.0	—	640	454	—	3
United Kingdom	50.9	22.6	9,461	7,768	186	344
United States	159.6	60.0	10,206	15,077	64	250

<sup>a</sup> Estimated for 1953.

<sup>b</sup> For various years between 1947 and 1954, depending on Census years.

<sup>c</sup> 1954; includes cost, insurance, and freight to point of import.

<sup>d</sup> 1954; free on board in exporting country.

SOURCES: United Nations, *Monthly Bulletin of Statistics*, various dates; International Labor Organization, *Year Book of Statistics*, 1955.

It is also important to have some idea concerning which countries trade with which other countries. Apart from wars, and their aftermaths, the trade of the world follows a fairly definite pattern.

TABLE 1.5

WORLD EXPORTS BY ORIGIN AND DESTINATION, 1954  
(f.o.b. value in millions of U. S. dollars)

Exports from	Imports into		1 United States	2 Canada	3 Latin America	4 Cont. West Europe	5 O'ceas; Terrs. of Cont. West Europe	6 U.S.S.R.	7 Soviet Satellites	8 Mid-East (non-Sterling)
	United States	Other								
1 United States	—			2,766	3,196	2,394	233	0	6	265
2 Canada	2,389			—	192	341	15	5	1	16
3 Latin American Republics	3,472			232	(699)	1,516	759	74	78	17
4 Continental Western Europe <sup>a</sup>	1,390			154	1,515	(10,296)	1,841	210	481	619
5 O'ceas Terrs of Cont West Eur	356			26	244	1,678	(188)	3	5	17
6 U.S.S.R.	12			1	0	219	1	—	•	20
7 Soviet Satellites <sup>b</sup>	30			3	60	375	4	•	•	45
8 Middle East (non-Sterling) <sup>c</sup>	147			4	34	598	10	27	44	(154)
9 United Kingdom	452			380	334	2,037	131	39	56	199
10 "White" British dominions <sup>d</sup>	264			37	13	764	39	38	23	14
11 India and Sterling Far East <sup>e</sup>	683			125	104	1,453	23	29	22	108
12 China	0			2	2	66	12	•	•	9
13 Japan	283			• 21	201	89	25	0	5	43
14 Other Far East <sup>f</sup>	490 <sup>•</sup>			5	19	356	14	0	6	5
World	10,097			3,763	6,690	22,760	3,315	583	775	1,563
Percentages by Grouping	14			5	9	29	4	1	1	2

TABLE 1.5 (Continued)

<i>Imports into</i> <i>Exports from</i>		9	10	11	12	13	14	World	Percentages by Grouping
United Kingdom		692	470	433				15,077	19
1	United States	674	107	95	0	678	669	3,986	5
2	Canada	587	23	77	4	204	6	7,914	10
3	Latin American Republics	1,914	480	929	63	116	503	21,634	28
4	Continental Western Europe <sup>a</sup>	216	42	70	0	6	13	2,974	4
5	Oceans Terrs. of Cont. West. Eur.	106	0	3	*	2	1	454	1
6	U.S.S.R.	81	9	20	*	5	11	743	1
7	Soviet Satellites <sup>b</sup>	136	102	81	12	143	11	1,702	2
8	Middle East (non-Sterling) <sup>c</sup>	—	1,714	1,751	19	33	84	7,768	10
9	United Kingdom	1,599	(316)	295	3	130	14	3,681	5
10	"White" British dominions <sup>d</sup>	2,091	335	(698)	84	282	67	5,278	7
11	India and Sterling Far East <sup>e</sup>	23	5	173	—	37	11	342	0
12	China	51	61	378	19	—	363	1,629	2
13	Japan	55	37	399	4	229	(59)	1,741	2
14	Other Far East <sup>f</sup>	8,765	3,718	5,888	282	1,941	2,100	(78,509)	
World		11	5	8	0	2	3		100
Percentages by Grouping									

<sup>a</sup> Unreported.<sup>b</sup> Less than half a million dollars.<sup>c</sup> Numbers in parentheses intra-group International Trade.<sup>d</sup> Continental Europe excludes Finland, Yugoslavia, and Spain.<sup>e</sup> Soviet Satellites include Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Rumania, and East Germany.<sup>f</sup> Middle East non-Sterling includes Egypt.<sup>a</sup> "White" British dominions include Australia, New Zealand, Union of South Africa, Rhodesia<sup>b</sup> India and Sterling Far East include Ceylon, Malaya, Hong Kong.<sup>c</sup> Other Far East includes South Korea, Indonesia, and Formosa.

NOTE: Aggregate of values by groupings does not entirely exhaust global totals.

SOURCE: Developed from United Nations, *Monthly Bulletin of Statistics*, August, 1955

Of course, with over 60 sovereign nations and 2,500 pairs of countries that can trade with one another, it is difficult to describe briefly the network of world trade. Hence, if trade patterns are to be understood, it is necessary to group many countries together and then describe the trade flows among these groupings. For some purposes it is useful to group countries according to their use of a common currency (such as sterling), according to their climate (such as tropical countries) or according to their geographic contiguity (such as Latin America).

Table 1.5 gives one possible set of groupings. If one looks along the United States row one sees the values of United States exports to different groups of countries. And if one looks down the United States column one sees the values of United States imports from different countries. It is clear that the United States sells more to the United Kingdom and Continental Western Europe than it buys in return. On the other hand the United States imports more from Latin America and from the Overseas Territories of Continental Western Europe than it sells in exchange. Thus the countries of Western Europe pay for some of their imports from the United States with dollars earned from the exports of their overseas territories. Once again the isolation of the Soviet Union is remarkable.

Even Table 1.5, with its 196 cells, is hard to grasp. Accordingly it has been further collapsed for presentation as Figure 1.1. In this case China and the Soviet Satellites have been combined with the USSR; all the Middle East and other Far East countries have been combined (including India and Pakistan); and the other British dominions and overseas possessions have been combined with the colonial dependencies of other European powers when these lie outside Asia. By aggregating in this rather heroic way the trade of the world can be described in terms of the merchandise movement among the following seven groupings:

1. The United States.
2. Dominions and Dependencies, including Canada, Australia, New Zealand, the Union of South Africa, the British West Indies, French

North Africa, and the overseas dependencies outside Asia of all European countries.

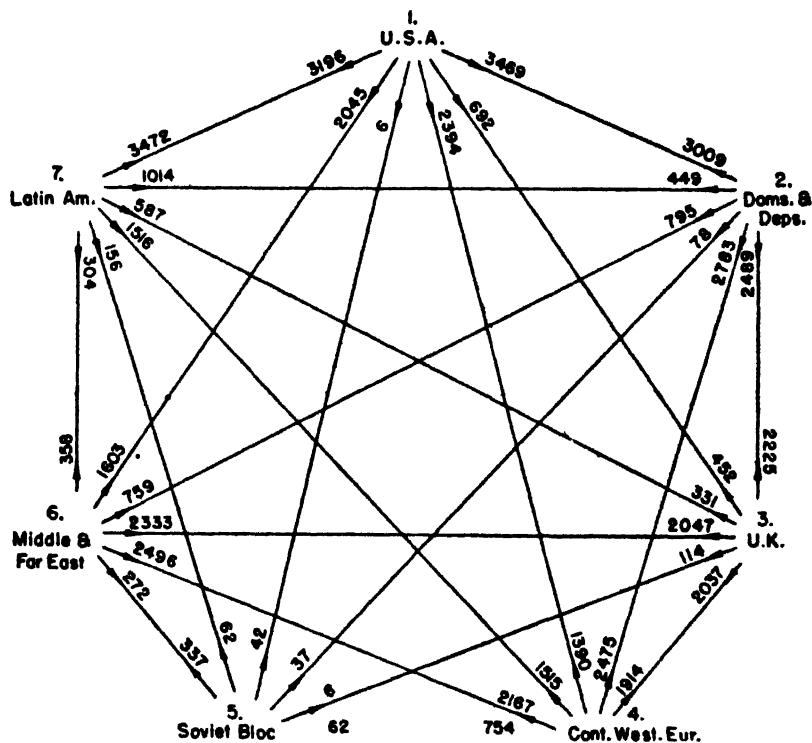
3. The United Kingdom, including Northern Ireland.

4. Continental Western Europe, excluding Yugoslavia, Spain, and Finland, but including the rest of Scandinavia.

5. The Soviet bloc, including China, Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Roumania, and East Germany.

6. Middle East and Far East, including Egypt, Turkey, India, Pakistan, Ceylon, Malaya, Burma, Indonesia, Japan, Formosa, Hong Kong, and South Korea.

7. Latin America, including all the independent republics but excluding dependencies of European powers.



SOURCE: Table 1.5.

Figure 1.1. The network of world trade (in millions of dollars).

The order of these seven areas—as a glance at the trade values in Figure 1.1 will show—is such that each area has a fa-

vorable trade balance with the next one. Actually the United States has a favorable trade balance with every one of the six other areas except Latin America and the Soviet bloc. The United Kingdom has an unfavorable trade balance with every other area except Continental Europe and the Soviet bloc. Latin America only has an unfavorable trade balance with the Middle and Far East area. Continental Europe only has a favorable trade balance with the Soviet bloc.

Of course some of these relations for 1954—especially those involving the Soviet bloc—may be reversed in later years. Moreover, the trade balance between Latin America and Continental Europe can change from year to year depending upon the relative price changes of the raw materials exported from Latin America and the factory-made goods exported in return from Europe. Finally, it must be remembered that nations earn foreign exchange from the sale of services also, and an unfavorable *merchandise* trade balance does not necessarily mean an unfavorable trade and service account.

Something should be said about the commodity composition of world trade. One quarter of this trade, in value terms, comprises the first dozen commodities listed in Table 1.6; the entire list ac-

TABLE 1.6  
LEADING COMMODITIES IN WORLD TRADE  
(ranked by value)

Petroleum	Tin
Cotton	Bacon
Coffee	Fish
Wheat	Butter
Pulp & paper	Tea
Wool	Corn
Rubber	Barley
Timber & lumber	Lead
Coal	Bananas
Sugar	Coconuts & copra
Copper	Zinc
Rice	Wine
Tobacco	Iron Ore
Jute & bagging	Citrus Fruits
Hides & skins	

SOURCE: *International Financial Statistics*, February, 1956.

counts for about a third of all trade. Petroleum occasions about 4 per cent, copper about 1 per cent, and hides and skins less than half of one per cent. Since these rankings and percentages change from year to year, no exact magnitudes are listed. It is worth remembering that these commodities, together with thousands of others, accumulate to an annual value of over 80 billion dollars, this being equal in value to the combined gross national products of Great Britain and the German Federal Republic.

### A CHANGING WORLD

Change is one thing that is constant in economic life. New products, new ways of doing things, new frontiers, new alliances, and new government policies all conspire to reorder international trade and investment. Amid a conflict of tensions the fortunes of different nations wax or wane.

Some of the changes that have occurred during the past fifty years are so remarkable that a few examples must be mentioned. The use of the internal combustion engine in place of steam, and the related change from solid fuels to petroleum products, has brought riches to those parts of the world that have developed crude oil resources (for example, Venezuela and Saudi Arabia) and reduced the importance of coal mining countries (for example, Britain). Airplanes are rapidly replacing ships and trains as a means of travel, and this benefits countries like the United States that have a comparative advantage in producing commercial airplanes and operating airlines. A host of synthetic products have deprived certain countries of much of their export demand. Malaya has suffered from the development of synthetic rubber, Australia and Egypt have suffered from the development of numerous synthetic textile fibers, and some timber producing countries have suffered from the development of plastic materials.

Within the next decade atomic power may do much for countries such as Italy that are now handicapped by inadequate sources of industrial energy. Nations that lack domestic petroleum or coal resources, and have few opportunities to exploit hydroelectric



power, may find these disadvantages removed if and when they can atomically produce electric energy for less than a cent a kilowatt hour. It is not surprising that Great Britain, now an importer rather than an exporter of coal, has already constructed an atomic power station that contributes energy to the national power system.

World War II brought many changes too. Communist expansion into the Balkans, Poland, and East Germany, severed most of the East-West trade that formerly flourished within Europe. Poland no longer exports wheat to Germany and France in return for factory-made goods. And in the Far East the communist domination of China cut another historic trade route with the Occident and places Japan in an extremely difficult situation. The Netherlands, as a result of the war's aftermath, lost Indonesia. Great Britain drew down two-thirds of her overseas investments during 1939-41, before United States entry into the war, thereby losing investment income for ever.

On the other hand the existence of the North Atlantic Treaty Organization has strengthened many economic ties. American forces stationed in Europe hire nationals and in other ways contribute dollar exchange that is used by the local economies to import goods from the United States. Great Britain produces combat planes for several NATO governments. Some of the equipment of the ground forces is being standardized: thus most of the NATO armies will use a Belgian designed automatic rifle. Within limits—but these have almost certainly not yet been reached—it is possible to attain a greater military effectiveness from a given defense budget through national specialization in production.

It is obvious that the trade of nations is greatly influenced by government intervention. Tariffs and quotas are familiar examples to Americans. But most European countries also have exchange control systems created before and during the war. In effect the government buys, at a set price, foreign exchange earnings of its nationals; and it then sells them back to importers and others, sometimes at different prices, under licence. Thus the government in each of these countries is in a position to limit imports of any class of good or imports from any given country. All sorts

of bilateral understandings are reached whereby one government will permit its nationals to buy more from another country if the latter's government will permit its nationals to buy more from the former country. In this way the old fashioned practice of back scratching has acquired some of the dignity of international diplomacy.

A survey of the leading powers reveals the continued rise of the United States, Canada, Australia, West Germany, and Belgium. Great Britain and France continue to decline relative to other great powers. There are some signs that Italy may be stirring from chronic overpopulation and underemployment. The economic futures of India and Egypt, despite the efforts of their governments and some measure of aid from abroad, remain ominous. While some nations are pressing on toward their destiny others are struggling to escape their fate.

### **THE UNITED STATES IN THE WORLD ECONOMY**

The United States has the largest national income in the world and the tonnage and value of the goods moving through its ports in foreign trade exceed those of any other country. Its government, corporations, and public lend more abroad than any other country. It makes larger gifts to foreign governments than any other country. It is the principal financial support of NATO. It has the largest merchant marine in the world, though much of it is laid up. It is therefore not surprising that most of the world regards the policies of the United States government and the fortunes of the American economy with mixed emotions of hope and fear. The older European economies especially are waiting to see whether this young giant will acquire the same maturity and sense of responsibility that they sometimes attribute to themselves.

One feature of the postwar era has been the continued shortage of dollars in the world economy outside the United States. At existing exchange rates a majority of nations would like to import more from the United States than they can actually afford to buy with their dollar earnings. For this reason many governments have

continued exchange control schemes that only permit their residents to have and use dollars—and usually other foreign currencies besides—for purposes approved by the exchange control agency.

It is wise not to exaggerate the extent of the dollar shortage in ordinary times. Much has been made of the fact, for example, that between 1914 and 1950 the value of the United States exports exceeded the value of its imports by about one hundred billion dollars. About three quarters of this was financed by the United States government, mostly as grants, but partly as loans. The balance was covered about equally by private remittances from Americans, private lending abroad by American corporations and investors, and by the liquidation of dollar assets by foreigners. However, it is well to remember that during this 36 year period there were two world wars lasting for a total of 10 years, two periods of relief and reconstruction for “victorious” and “vanquished” countries alike in Europe, and several years of severe economic depression during which United States foreign loans and commodity imports ceased or declined.

Today, with the world past the mid-fifties, the relevant question is whether the dollar shortage will slowly disappear or become chronic: although it is dangerous to predict, some considerations can be mentioned.

The United States, especially when its home economy is booming, is a great importer of raw materials and some food products, largely from Canada and Latin America, but also from the Middle East and Far East. Table 1.7 indicates some of the imports upon which the United States economy depends. Many are traditional, but others, such as petroleum and iron ore, are really postwar developments. Moreover, as the population of the country grows and some of its choicest natural resources approach exhaustion, the propensity of the United States to import, as a function of per capita income, is likely to increase. Of course this occasions some foreign worries because another depression in the United States could seriously reduce foreign exports to this country, and so in turn depress economic activity abroad. It has been said—with humor

TABLE 1.7

## SOME IMPORTS OF IMPORTANCE TO THE UNITED STATES

*most all consumption imported*

Crude rubber	for tires, medical supplies, corsets, etc.
Tin	tin plate, bronze, bearings, etc.
Coffee	beverage
Raw silk	apparel and hosiery
Carpet wool	carpets
Jute and burlap	bags, wrapping, material, carpets
Diamonds	industrial cutting, adornment
Nickel	steel alloys, filaments, etc.
Cacao	beverage, chocolates, etc.
Bananas	food
Tea	beverage
Tung oil	quick-drying varnishes
Manganese ore	steel alloys, batteries, etc.
Spices	flavorings
Asbestos	insulation, friction equipment, brakes, etc
Chromite	stainless steel
Manila (Abaca) fibre	cordage
Crude chicle	chewing gum
Quebracho	leather tanning
Cobalt	cutting tools

*About two-thirds consumption imported*

Newsprint	for newspapers, magazines, etc.
Sugar, raw	sugar refining
Furs	apparel
Flax seed	linseed oil, animal food
Tungsten	alloys, cutting tools
Bauxite	aluminum

*About one-third consumption imported*

Petroleum	for petroleum products
Iron ore	ferrous metals
Wood pulp	paper and paper board

and some truth—that when the United States sneezes the rest of the world comes down with pneumonia.

The government of the United States is also likely to continue to provide dollars in substantial number to backward countries for development and to allies for military equipment. The magnitude of these transfers can fluctuate seriously from year to year. However, in the mid-fifties, annual payments for economic aid have run from one to two billion dollars a year, and military expenditures abroad or for the accounts of foreign governments have been running from

two to three billion dollars a year. Many of these expenditures are directly for United States exports, but the final effect in all cases is to increase the sales of American firms. Most dollars that go "abroad" are spent rather promptly on goods and services from America.

In recent years the nature of private American lending has differed considerably from that of the inter-war period. Then there was a great deal of portfolio investment by commercial banks and individuals in the securities of European governments and companies. Today there is relatively little private investment by Americans in Europe. Moreover, the place of portfolio investment has been largely usurped by that of direct investment, which occurs, for example, when a United States company develops an oil field or constructs a smelter abroad. A great deal of this direct business investment, and some private portfolio investment besides, is being made in Canada. In fact some Canadians have been heard to complain that they no longer own the country they live in.

There are people who argue, however, that some degree of dollar shortage in the world is likely to be chronic. They base their argument on two main grounds. First, most of the new products and techniques are nowadays initially developed and commercially produced in the United States: current examples are atomic power reactors, electronic computers and data processors, and large high-speed commercial airliners. Second, because of the "selling" influence of United States movies, tourists, and armed forces personnel abroad, foreigners soon learn about American products and living standards, and want them too. Unfortunately there is often a considerable time lag before foreign economies can produce these goods at comparable prices. And in the case of goods that depend for a low price on mass production this may never happen. Hence, it is alleged, much of the dollar shortage stems from sumptuary aspirations abroad that exceed the productive capabilities of foreign economies.

Other writers have laid some of the blame for the dollar shortage on the protective trade policies of the United States government. They have pointed out that, a hundred years ago, the United King-

dom, in technology and production, was as much ahead of the rest of the world as the United States is today. And yet there was then no chronic sterling shortage as now there is a dollar shortage. The explanation has been advanced that Great Britain in the 19th century adopted a policy of free trade and made large foreign investments whereas the United States today has numerous tariffs, imposes quotas or embargoes on many foods and raw materials, and subsidizes its merchant marine in competition with foreign flag ships. Of course private investments were more secure in a century when marines could be landed upon the shores of any country that threatened to confiscate investors' property or harass the operations of their companies. And it was impossible for there to be a sterling shortage when all leading powers were on an automatic gold standard. Nevertheless, these caveats apart, it is important to consider the impact of special domestic interests upon foreign trade policy and to ask ourselves whether the Congress of the United States has done all that it might to enable foreign countries to *earn* their dollars. It is trade, not aid, that they profess to want.

### DOMESTIC POLITICS AND INTERNATIONAL TRADE

Few economic issues generate so much political heat without light as do questions concerning international trade policy. In every country there are super patriots, encouraged by special interests desiring more protection for profits, demanding greater defenses against the invasion of foreign goods. These gentlemen forget to mention that while cheap imports may threaten uneconomic home production they also advantage the firms and households that use them.

In fact one of the greatest fallacies encumbering any discussion of trade policy is the notion that there is an inevitable conflict of interest between importing nations and exporting nations. The issue is usually presented as though a reduction in a particular tariff will injure the home country while benefiting the foreign countries that export the commodity. In reality though the conflict of interest is not *international* but *intranational*. The political battle lines really

should be drawn between producers and consumers in both the importing and exporting country. A tariff reduction will lower the price in the importing country and raise it in the exporting country. In the importing country then there is some loss for competing producers but gains for users. In the exporting country there is a gain for producers but a loss for users. In a more rational world, given the necessary political institutions, the importing users and exporting producers should ally themselves against producers in the importing country and consumers in the exporting country. But this, of course, is not what happens.

In practice trade policy tends to be made piecemeal. The issue that arises is usually not whether a country should import more or less of *everything* but more or less of *something*. Usually the question considered by a congressional committee, or an official in some administrative agency, is whether the duty or quota on, say, imported widgets should be raised or lowered. All the producers of widgets, together with spokesmen for their employees and local communities, then become convinced that the country (or at least themselves) will be ruined if protection against imported widgets is reduced (if not increased). The users of widgets on the other hand, especially if they are ordinary consumers for whom widgets constitute a small part of the family budget, will probably not bother to send telegrams to their congressmen urging freer imports. In any political conflict of this kind the special interests nearly always triumph over the general interest because the latter remains unorganized.

There are always some exceptions. If the imported commodity is an important input of domestic producers, they too will have a special interest to present. And, though in a more general and attenuated way, large domestic exporters may realize that foreigners cannot buy their output unless the home country imports other goods from abroad. Thus American growers of tobacco and producers of automobiles have an interest in encouraging United States imports of noncompeting goods. If it were not for this rather scattered support for freer trade, import restrictions would be even greater than they are.

Most pleas for protection imply that international trade is somehow different from intranational trade. The Senator from Illinois can probably be persuaded to vote against increased imports of lumber from British Columbia, but he sees little wrong with importing lumber from Washington State into Illinois. The Senator from California probably votes against foreign shoe imports but he welcomes the importation of Massachusetts shoes into California. Both senators would be slightly amazed if it was suggested that Illinois and California should each strive to be more self-sufficient as regards lumber and shoe production. Why, they might even point out that California can hardly expect to sell her produce throughout the United States if she won't buy from the other 47 states, and likewise in the case of Illinois. How does this paradox arise?

The distinction between international trade and intranational trade is more one of politics than economics. Individual states do not have authority to restrict imports from other states, and so the issue does not arise. However, if the constitution were amended so that this power was vested in each of the states, it is not difficult to imagine the unhappy results. It would not be long before lobbyists at the state capitals would be pointing out that local producers were suffering unfair competition from other states' exports. It would be emphasized in Sacramento that hourly wage rates are on an average lower in Massachusetts than in California. And in Springfield the dangers of Illinois becoming too dependent on foreign lumber sources would be urged upon the legislature. Fortunately this nightmare of nonsense remains a dream thanks to the sagacity of the drafters of the constitution.

This distinction between economic circumstance and political authority can be understood in another context. Let us consider the United States and Canada—two countries having very similar economic and cultural characteristics—and ask ourselves why they should not enter into a customs union within which there would be free trade. A number of real and legitimate problems would first have to be settled that only arise because each country, as a sovereign nation, now exercises certain kinds of authority that are not possessed by individual states within the American union. For ex-



ample, migration of labor from Canada to the United States is restricted, and would it make much sense to continue these not very onerous restrictions if the product of Canadian labor is to be imported freely into the United States? Also, the United States and Canada both have their own currencies, and should their fiscal and monetary policies differ markedly the relative values of the two currencies would change from time to time. Moreover, and this might prove a great difficulty, there would have to be a negotiated agreement between the two nations on their trade policies toward the rest of the world before all customs barriers between the two countries could be removed; Canadian exporters to the United Kingdom might be loth to terminate imperial preferences. Finally, and perhaps the most important reason why this customs union will not happen, is that there will be producers in the United States who will be hurt by Canadian goods, and producers in Canada who will be hurt by American goods. The producers will organize. The consumers will not. And so the question remains academic.

International trade differs from interregional trade, within a free trade area, because it must survive despite special interests which can employ the power of government on their behalf. It does not, however, differ in its essential economic characteristics. International trade occurs for the same reasons and confers the same benefits as intranational trade. However it has more obstacles to surmount and therefore it tends to occur only when and where the mutual benefits are especially marked. These benefits must be considerable because, despite all the attendant difficulties, world trade amounts to over eighty billion dollars a year. In a freer and less selfish world this trade and these benefits would be considerably greater.

3. "America's high output per man-hour is based on our puritan heritage, not on land-labor and capital-labor ratios." *Evaluate.*

4. "It is not fruitful to speak of a country as a whole as having lower labor costs than another country." *Explain.*

5. "We can define change in a given country with enormously greater precision than we can define differences, especially those relating to income, between countries." *Explain.*

6. "The term 'comparative advantage' is just another way of describing the business principle 'use your resources to best advantage.'" *Explain.*

7. "The Dutch, relying heavily on international trade, are peculiarly vulnerable to competition from foreign low-wage countries." *Evaluate.*

8. "In a large and well-developed country with diverse resources international trade would be relatively small even if there were no man-made barriers to trade." *Explain.*

9. "Wool comes in large part from areas of limited rainfall or of low fertility, not because the sheep prefer that sort of land, but because crops and other livestock provide so much competition. Such sheep land is not absolutely better suited for raising sheep." *Explain.*

10. "If foreign producers pay lower wages than American producers, everything else being equal, foreigners are going to produce for less than American producers. But other things aren't equal." *Explain.*

11. "To speak of America's growing dependence on foreign raw materials is to try to make the public's flesh creep with warnings of possible disaster; we can always turn to synthetics." *Evaluate.*

12. "The prosperity of manufacturing in many American cities has forced our farmers to use methods that are unlike those used in, say, Asia." *Explain.*

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**PART II**

**PRINCIPLES OF FOREIGN  
TRADE AND LENDING**



## **A Brief Survey of Trade Theory**

During the past few centuries economists have evolved a body of theory that seeks to describe the ways in which national economies trade and interact with one another. Some of the earliest views evolved by the so-called classical economists are outlined in Appendix B. In the present chapter a brief synthesis of international trade theory as it exists today will be presented. More detailed chapters follow this preview. Finally, in the chapter entitled "Controlled Disequilibrium," some consequences of government interference with normal economic adjustments are described.

### **PLAN OF PRESENTATION**

In this chapter we will consider two economies that we will call the United States and Canada although, being abstractions, they do not closely resemble these countries as we know them. First, we shall consider the trade of a single commodity. Second, we shall consider the case of two commodities and develop the principle of comparative advantage. Third, we shall assume that the value of exports equals the value of imports, and consider briefly the manner in which currency exchange rates are determined. Fourth, we shall assume that these two countries are potential buyers and sellers of many goods, and investigate what it is that determines

which goods *are* exported and imported. Fifth, the possibility of international capital transfers will be added. Sixth, the argument will be generalized for many countries. Seventh, we shall consider the influence of national income and domestic monetary policy on international transactions. Finally we shall examine reasons for changes in the so-called terms of trade. At the end we should have a fairly complete although somewhat superficial impression of how the economy of a single nation interacts with those of other countries.

### SINGLE COMMODITY TRADE

Both the United States and Canada grow wheat. However, we will suppose that, in the absence of any trade in wheat between these two countries, the price in Canada would be lower. It may be lower because supply costs or demand prices are lower in Canada. Supply costs will be lower, for example, if output per man in wheat-growing is higher in Canada or if wages per man are lower. Demand prices may be lower because the number of consumers is small or because their incomes are low and they cannot afford to pay a high price. Regardless of the causes, the important fact here is that there will normally be a movement of wheat from Canada to the United States if, in the absence of trade, the price in Canada would be lower than the price in the United States.

This price difference stimulates wheat exports from Canada to the United States. The volume of this trade will be such that the price difference is eliminated. The final equilibrium price will cause the sum of the quantities demanded in both countries to equal the sum of the quantities supplied in the two countries together.

A qualification must be made on account of transport costs, however. If it costs 10 cents a bushel to move wheat from Canada to the United States, the final price in the United States will have to be just 10 cents above the final price in Canada. At the final Canadian price the excess of supply over demand in the Canadian market must just equal the excess of demand over supply in the United States market at the final United States price. That is to say, the

amount the Canadians want to export must equal the amount the Americans want to import if the prices in the respective markets are truly equilibrium ones.

This trade in wheat, by altering prices in the two countries, changes the quantities demanded and supplied in the two economies. The consequence of trade is to raise the market price of wheat in Canada so that Canadians produce rather more and use rather less than they otherwise would. In fact, these two reactions create the surplus available for export. Conversely, the lower American price for wheat increases use and decreases production in the United States, and this in turn creates an import demand.

## TWO COMMODITIES AND COMPARATIVE ADVANTAGE

Clearly there must be trade in both directions, or the Canadians would be accumulating American money they couldn't use. In practice, they will import some commodity, such as cotton, from the United States in exchange. The immediate stimulus to import cotton will again be that, in the absence of such trade, the American price would be lower than the Canadian price by more than the transportation cost separating the two markets. In extreme cases, such as cotton in Canada, the final price in the importing country may be too low for any domestic production.

When this two-way trade in wheat and cotton has become stabilized it is possible to consider the real costs and advantages that stem from these international movements. However, it is first necessary to know the output that can be had in the United States and Canada *per man-day* of labor engaged in growing and harvesting wheat and in raising and picking cotton. We shall suppose that these are:

	<i>United States</i>	<i>Canada</i>
Wheat (bushels)	10	8
Cotton (pounds)	30	2

The enormous assumed difference in cotton production is due to the Canadian climate, which we will suppose necessitates the use of enormous greenhouses if cotton is to be raised.



It is immediately apparent that the United States has an *absolute advantage* in both lines of production. In America a man-day of labor produces 2 bushels more of wheat and 28 pounds more of cotton than in Canada. However, if these countries are trading, it is the *comparative advantage* of each nation that matters. Clearly, the United States has a greater advantage in cotton (producing 15.0 times as much per man-day) than it has in wheat (producing only 1.25 times as much as Canada). Apparently, unless these comparative outputs are changed thereby, the United States should produce its own cotton and export some to Canada, receiving wheat in exchange. Canadians should obtain their cotton by producing wheat for export and taking cotton imports. Both countries benefit from this national specialization and international trade.

How this gain from trade will be shared by the two countries depends upon the strength of the demand in each country for imports from the other. We shall suppose that the equilibrium involves 1,000,000 pounds of cotton being exported from the United States in exchange for 500,000 bushels of wheat from Canada. Thus the trading ratio is 2 pounds of cotton to 1 bushel of wheat. This means that a man-day of labor in the United States produces 30 pounds of cotton that can be exchanged for 15 bushels of wheat. The same man-day in wheat production in the United States would have yielded only 10 bushels, or 5 bushels fewer. The Canadians also gain from this trade, for a man-day there, in wheat production, yields 8 bushels that can be exchanged for 16 pounds of cotton, 14 pounds more than a man-day of Canadian labor could have produced directly. Hence both countries benefit from specialization.

If the American demand for wheat were to increase, the trading ratio, other things being equal, would turn somewhat against the United States. Thus it might take 3 pounds of cotton exports to obtain a bushel of wheat imports. In economic life one's bargaining position always seems to deteriorate when one wants something more urgently.

This notion of comparative advantage is an extremely important one and applies to ordinary human affairs. It would be folly for

a lawyer to type his own letters even though he may be a better typist than his secretary, for his legal services are worth far more than her typing services, and she is untrained in law. Similarly, because a country such as the United States may have an absolute physical advantage in many lines, it should not undertake those in which it has a *comparative* disadvantage.

### PAYMENTS BALANCE AND EXCHANGE RATES

Of course, exporters and importers react to *prices*. They know little of real labor costs and care less about the comparative advantages that their home countries may possess. Hence, to complete the explanation of how prices of traded goods are determined, we must consider the role of exchange rates when different national currencies are involved.

The prices that interest Canadians are those that are expressed in Canadian dollars, while Americans naturally think in terms of prices expressed in their own national currency. Thus the American importer of wheat must convert the Canadian price of wheat into American dollars. He looks at Winnipeg wheat prices "through the exchange rate," as it were. Thus, if it takes 95 cents to buy a Canadian dollar and the price of wheat in Winnipeg is 1.05 Canadian dollars per bushel, the American importer says the price to him is really .95 of \$1.05. And the Canadian importer of cotton, seeing that the price of cotton per pound is 50 cents in New Orleans, calculates that the real cost to him in his money is \$.50 divided by .95. This is all obvious enough.

But how is the exchange rate between these two dollar currencies determined? Although this is explained in detail in Chapter 9, it will suffice to say here that the United States price of a Canadian dollar is determined by the total quantity of Canadian dollars being sought by Americans (selling United States dollars) compared with the total quantity of United States dollars being sought by Canadians (selling Canadian dollars). The more American dollars

that are sought by Canadians the cheaper will be the Canadian dollar when priced in American currency.

So far we are assuming only two countries (the United States and Canada) and only two commodities (wheat and cotton). Hence, more or less, the value of Canadian wheat exports must in any period equal the value of American cotton exports. In the absence of other international transactions, the prices of wheat and cotton in the two markets and the prices of each currency in terms of the other, must all mutually adjust to make this so.

Let us assume that part of the outcome is that 500,000 bushels of wheat are exported in each period at a Canadian price of 1.05 dollars: this means that American importers must find 525,000 Canadian dollars. Also let us suppose that the result includes cotton exports of 1,000,000 pounds at a United States price of \$.50: thus Canadian importers must find 500,000 United States dollars. These two demands acting upon one another—the Canadians seeking United States dollars and the Americans seeking Canadian dollars—should result in a United States price on the Canadian dollar of 500,000 divided by 525,000. This is about 95 cents United States per dollar Canadian.

The exchange rate plays a most important part in bringing two economies into adjustment when each nation has an inconvertible paper currency that can be freely bought and sold. If rust destroys part of the Canadian wheat crop, raising the price of wheat in Canada, Americans will import fewer bushels. If the American demand for Canadian wheat is elastic—as can probably be assumed—American importers of wheat will not have to find so many Canadian dollars. As a consequence the value of the Canadian dollar will fall. The change in the rate of exchange further adds to the difficulties of Canada because the price to Canadians of American cotton is raised thereby. Canadians will therefore import less cotton at this higher price to them. In other words, inasmuch as Canada has less wheat to export because of wheat rust, she is not in a position to import so much cotton. The physical facts of life have in part been brought home to the Canadian economy through modifications of the exchange rate.

### MANY COMMODITIES: WHICH ARE TRADED?

We can now relax our assumptions and suppose that the United States and Canada are potential exporters or importers of a variety of goods and services.

Table 2.1 considers four commodities which, ignoring transport costs for the moment, will either be imported or exported by the United States, depending upon the exchange rate. The first two columns show the "isolation prices" that would prevail in the two domestic markets, expressed in *domestic* currencies, if no trade were possible for some reason. The third column shows the "critical exchange rate": if the United States price of a Canadian dollar is less than this rate the United States will import, and if more it will export. Thus, taking coal as an example, it will be exported from the United States if the Canadian dollar costs more than 89 cents in New York, and it will be imported if it costs less.

TABLE 2.1  
THE EXCHANGE RATE AS A DETERMINANT OF WHICH GOODS ARE  
EXPORTED AND IMPORTED

<i>Commodity</i>	<i>United States "isolation price" (United States dollars)</i>	<i>Canadian "isolation price" (Canadian dollars)</i>	<i>Critical Exchange Rates (United States price of Canadian dollar)</i>
Cotton (per lb.)	\$ .50	\$ 7.50	\$ .07
Coal (per ton)	8.00	9.00	.89
Lumber (th. bd. ft.)	80.00	60.00	1.33
Wheat (per bu.)	1.20	.75	1.60

NOTE: The United States will import if the exchange rate falls below the critical rate and export if it rises above the critical rate.

Thus, narrowly considered, the exchange rate determines whether a good is imported or exported. More broadly considered, the exchange rate itself is determined by the domestic market prices that would prevail in each country in the absence of trade.

If the Canadian dollar has been priced at one dollar in New York, but now for some outside reason begins to cheapen, the United States will (according to the table) begin to import rather than export coal when the exchange rate falls below 89 cents. This will bring Americans into the market buying Canadian dollars, take Canadians out of the market who had been buying American dollars, and arrest the fall in the value of the Canadian currency.

In the absence of capital transfers, and ignoring freight costs for the moment, the value of all American exported goods and services must equal the value of all American imported goods and services. If this is not so the exchange rate will adjust. And when it adjusts the demand and supply of foreign monies in the exchange market adjusts, because the international movement of goods and services has become altered.

The main effect of freight costs, so far ignored, is that the regulatory effect of the exchange rate is somewhat deadened as regards any specific good. A change from \$1.59 to \$1.61 in the New York price of Canadian money will not reverse the direction of trade in wheat if it costs 10 cents a bushel to ship wheat from one country to the other. There will then be a range of 10 cents in the exchange rate within which wheat will not be worth trading between the two countries. In practice, though, there are thousands of commodities that are actually traded or almost tradable so that a one cent change in the exchange rate will terminate trade in some goods and instigate trade in other goods. As a result, the supply and demand for foreign exchange will alter, and in turn modify the exchange rate.

### CAPITAL TRANSFERS AND MERCHANDISE TRADE

International transactions do not comprise only exports and imports of goods and services. United States investors may decide that they wish to lend money to Canadian enterprises and American companies may establish branch factories north of the border. In this event more Americans will be wanting more Canadian dollars

so that they can either buy Canadian securities (portfolio investment) or construct and equip Canadian plants partly using local labor and materials (direct investment).

The consequence of this increased American demand for Canadian dollars is to raise the New York price of Canadian exchange—say from \$.95 to \$1.05. As a result, imports from Canada seem about 10 per cent more expensive, and Americans buy fewer of them. But Canadians will be purchasing more imports from the United States. Thus the physical result of the capital transfer is that fewer goods move south and more move north. In this way long-term investment modifies merchandise trade.

The sequence of lending and trading may be the reverse of that described above. Canada might somehow manage temporarily to buy imports of greater value than it can pay for with its exports. United States sellers may be forced to extend credit. In this case there has been short-term lending that was induced by merchandise trade changes. As Canadian solvency has been adversely affected it is possible that the Canadian currency will depreciate. This should stimulate Canadian exports, and inhibit Canadian imports, so that Canada emerges with a trading surplus that can be used to pay off the accumulated short-term debts.

One of the remarkable aspects of economic affairs is that all these related events occur because of people acting from selfish motives, usually ignorant of the larger significance of their actions. The American importer who buys less because the Canadian currency has appreciated does not modify his behavior because he wishes to facilitate a transfer of long-term capital from the United States to Canada. The American investor who bids up the price of Canadian dollars does not care that this result modifies merchandise trade between the two countries in such a way that he is able to invest abroad.

If Canada and the United States traded only with one another, and a corps of accountants had sufficient information to draw up a *balance of payments* (see Chapter 7) at the end of the year, they should find that all the United States transactions that resulted

in "credits" would have to equal in value all United States transactions that resulted in "debits." Exports occasion credits and lending abroad occasions debits. Thus, ignoring money transfers, which are usually insignificant, except over short periods, the United States could hardly have a "favorable" export balance (a net credit) unless it had a "lending" capital balance (a net debit) of approximately equal value.

### NATIONAL INCOME AND THE TRADE BALANCE

A feature of economic life, and one that influences the trade balance, is a fluctuating national income. Increasing money incomes in a country are associated usually with increasing economic activity and/or increasing bank balances. Under these circumstances the national economy tends to import more goods and lend more abroad; this in turn tends to depreciate the international value of the country's money, increase the incomes of foreigners, and eventually restore equilibrium.

Let us assume that American business is expanding and money incomes rising. This will normally mean that the number of dollars each family spends and saves will be increasing. The increased spending is mostly on domestically produced goods and services: but some of it will be on goods produced abroad and some on goods produced at home but with materials that are imported. It is surprising how many domestically produced goods contain foreign materials; and some are made with imported equipment. Thus one aspect of expanding business activity is likely to be an increase in the quantity and value of imports.

Moreover, if people save more dollars as their incomes rise, they will wish to add to their investments. In time the attractiveness of domestic investments may decline as the prices of home securities are bid up. Moreover, investors may wish to diversify their portfolios, through adding certain foreign investments. This increase in lending abroad will further augment the supply of dollars seeking foreign currencies in the exchange markets.

### MANY COUNTRIES AND MULTILATERAL TRADE

At this point we have almost emerged from our earlier cocoon of restrictive assumptions and can easily handle the more realistic case of many countries trading varied goods and making numerous loans.

Even if a country annually exported goods of the same value as it imported—which is not necessary—there is no reason why it should have an even trade balance with each and every country. Thus the United States may have a “favorable” trade balance with Canada, which might conceivably have a “favorable” trade balance with Latin America, which in turn may have a “favorable” trade balance with the United States. This is called multilateral trade. Although it is often argued that a country should import from those nations that buy its exports, and governments sometimes pay heed to these demands by consummating bilateral agreements, the trade of the world if left to itself tends to be multilateral with each pair of countries having an uneven trade balance.

There is no necessary reason why a single nation's exports and imports with all other nations should exactly balance. United States exports to Canada may be partly financed—although this may not be recognized by the businessmen involved—through American lending to other countries, which causes them in turn to import goods from Canada. The real requirement is that any export trade balance be offset by a lending capital balance, or any import balance with a borrowing balance, with *each* separate country and hence with all nations.

An increase in imports (debits) and lending abroad (more debits) will cause the dollar to lose value abroad. Foreign goods will seem more expensive to Americans, and United States goods will seem a little cheaper to foreigners, so that imports decrease and exports increase to some extent. Moreover, it must not be overlooked that foreign nations will then export more to the United States so that the money incomes of foreigners are increasing too. They too will spend and save more, partly on United States goods



and United States investments. Ultimately, the overall increase in the import trade balance should be rather smaller than was originally expected. (If the United States originally had a substantial *export* trade balance, financed by lending abroad, the rising national income might reduce the export balance rather than create an actual import balance.)

There is also always the possibility—one that many foreigners in fact fear—that a United States depression will spread to other countries as the United States reduces imports and lending. In the thirties economic depression did spread from country to country, because each nation reduced its flow of payments to other nations as its own national income fell. In this way the economic illness proved to be contagious. (See Appendix A for a rigorous treatment of these interactions.)

### THE TERMS OF TRADE

Fluctuations in national income, particularly when they are considerable and spread to other economies, tend to alter the so-called terms of trade.

In the United States the Department of Agriculture has long estimated indices of the prices of some goods that farmers buy and the prices of some goods that they sell. Similarly, statisticians can estimate a price index including some imports and some exports of a nation. If the export price index rises faster than the import price index, or falls slower, it is said that the terms of trade of that country have improved. This means that a given quantity of exports now buys a larger quantity of imports.

The effective price of imports is determined in part by the exchange rate. Anything that depreciates the home currency in foreign exchange markets tends to make imports more expensive and so worsens the terms of trade. Rising money incomes at home, if other things remain equal, will have this effect. Large scale lending abroad will have the same consequence.

More important, though, is the tendency of raw material prices to fluctuate by a larger percentage than do the prices of manufac-

tured goods. Thus, when the leading economic powers are prosperous, the raw material exporting countries find the prices of their wool, rubber, petroleum, lumber, and copper exports rising proportionately far more than the prices of the clothing, tires, gasoline, furniture and electrical equipment they import. Countries like Great Britain, on the other hand, find world-wide prosperity to be a mixed blessing. She may increase her export trades sales, and so earn more foreign exchange with which to pay for imports, but each motor car or bolt of cloth shipped abroad may buy a smaller quantity of rubber and cotton.

Sometimes there is a slackening in the world demand for the goods in the production of which a country has a comparative advantage. Thus Great Britain's economic expansion in the 19th century was largely based on coal, steam engines, and railroad equipment. But the 20th century is dominated by petroleum, the internal combustion engine, and increasingly, the airplane. Consequently Great Britain's terms of trade have also worsened in the sense that more kinds of things have now to be imported while the world market for many export lines has become quite limited.

The terms of trade are not the most significant measure of a nation's economic well-being. A country may still benefit itself by selling a much larger quantity of exports for a somewhat larger quantity of imports. However, an examination of changes in the terms of trade does help to determine which countries are benefiting most from general prosperity or which are suffering most from general depression.

### **CONCLUDING COMMENT**

It is important to realize that each national economy is bound to those of other countries by many bonds. These bonds are imports and exports and lending and borrowing, because all these transactions give rise to payments. These payments tend to spread prosperity and, in their absence, depression from country to country. Moreover, any change in the balance of payments affects the currency rate if there is no government interference. A depreciating

currency tends to encourage physical exports and discourage imports; and this in turn tends to increase the foreign exchange being offered for the local currency. Through merchandise trade the producers and users of a given commodity are linked together in an international market; rising labor costs in one country will lead to reduced use and increased production in another nation. No government action is needed to ensure that each national economy will adjust itself to the world economy. In fact, most continued maladjustments are due to government interference in economic affairs; left alone they would return to equilibrium.

### PROBLEMS

1. "It is rather paradoxical that the *cause* of international trade in a commodity is a price difference between two countries but the *result* is to eliminate this price difference except for freight and other transfer costs." *Explain.*

2. "The effect of international trade is to raise the price of the traded good in the exporting country, thereby benefiting all in that country." *Evaluate.*

3. "Exchange rate fluctuations should not be tolerated by any responsible government because they accentuate international maladjustments." *Evaluate.*

4. "In the real world it is not possible, except for a few months at a time, for Nation A to export goods of greater value to Nation B than it buys in return from B." *Evaluate.*

5. "When the United States economy sneezes, other countries catch pneumonia." *Explain.*

6. "In economic affairs the selfish actions of traders and foreign exchange dealers may help to restore international equilibrium." *Exemplify.*

7. "A country that imports raw materials and sells factory-made goods may find that world-wide prosperity is a mixed blessing." *Explain.*



## CHAPTER 3

# Why Nations Specialize

National specialization in production is one of the outstanding facts of economic life. It is rather remarkable, for example, that so many of the world's watch movements are made in Switzerland and that so much of the world's wool is grown in Australia. This is all the more surprising when one reflects that this specialization continues despite the increased transportation and customs costs occasioned by international trade. Clearly, different nations must possess overwhelming advantages in certain lines of production, but why is it that the "isolation price" (as defined in the preceding chapter) of a given commodity may be so much lower in one country than another? Climate is certainly a major element—for example, cotton cannot actually be produced in Canada. Another potent cause is that different countries are differently endowed with productive factors. In some nations land is abundant whereas labor is scarce; in other countries the reverse is true. The location of industry in one region or country is also influenced by the desire to minimize the freight bill incurred for moving raw materials and final products. These and several other bases of national specialization will now be examined.

### CLIMATE

Climate obviously has an important bearing on the production costs of almost all agricultural commodities and a number of manufactured goods. This is so patent that little elaboration is needed.

Climate, in fact, was one of the first aspects of geographic specialization to be seized upon by earlier economists.

Temperature and rainfall are two extremely important climatic elements affecting international trade. It is not only the average temperature throughout the year that matters, but also the variation and timing of temperature changes. The same is true of rainfall.

For example, cereals can be grown at high latitudes having a low mean annual temperature if there is a sufficiently long growing period free from killing frosts. Wheat needs a reasonable amount of rainfall during most of the year, but ripens best under dry conditions. Rice, on the other hand, does best with continuous warmth and dampness, and for this reason it is more abundant near the tropics than elsewhere. A damp, hot climate is necessary for the production of tree rubber. Most fruits and vegetables prefer a Mediterranean climate, which is cool and damp some of the year and hot and dry during the remainder. Citrus trees cannot live in regions of frequent frost. Forest products come from areas having a high rainfall. Indeed, all agriculture is so dependent on the temperature and rainfall characteristics of a region that an economic geographer can deduce a country's climate from its vegetable products.

Climate is also important in lines of production other than agriculture. Lancashire, England, was long an important center of cotton spinning because the damp air caused the cotton fibers to bind more tightly. One of the reasons that southern California became the home of motion pictures was that in the days of silent films, when nearly all pictures were made outdoors, almost every day was sufficiently sunny for scene-shooting. Factories do not have to be well built in temperate zones as in zones of extreme variations of climate, and they can sometimes be in part dispensed with where the weather is normally dry. For example, some of the assembly work on aircraft in the Los Angeles area is performed outdoors. On the other hand, extreme climates usually increase production costs simply because employees must be given comfortable working conditions if they are to work efficiently.

Differences in climate were an especially important basis of international trade several centuries ago. The famous spice trade of the Middle Ages, which brought cinnamon and nutmeg, among other rarities, from the East to Europe, would not have existed had the western climate permitted their growth locally. The British Isles, before the Napoleonic Wars, were a large importer of wines from the warmer regions of southern Europe. In the past the cooler temperate regions have relied on the tropics for sugar, coffee, and rubber, and on the intermediate zone for tea, cotton, and tobacco.

However, climatic differences, although still a potent force, are becoming a less important cause of international trade. First, new strains of familiar vegetable products that are adaptable to a wider climatic range are constantly being developed. For example, new types of wheat that have a very short growing season can now be raised at high latitudes. Beet sugar produced in temperate zones has been substituted for much of the cane sugar grown nearer the tropics. Second, certain aspects of climate can be modified by human ingenuity, and often at low enough cost to prove practicable. Where climate does not provide rainfall it is often possible to irrigate. This has been done in parts of Palestine, for example, with great success. Cotton-spinning can be performed in dry regions if proper air-conditioning is installed. Third, many natural products are and can be replaced by other materials. Synthetic rubber is able to replace tree rubber in some uses, even on the basis of competitive costs. Fibers such as cotton, silk, and wool are being in part superseded by rayon, nylon, and eventually perhaps by spun glass and steel. The lighter metals are competing ever more successfully with wood for building purposes and for furniture.

Some of these new processes and products are admittedly in their infancy. The scientifically advanced nations of the world, however, are now on the threshold of a technological revolution which will introduce many synthetic products still only in the laboratory stage. These synthetic goods will partially replace many of the natural products upon which man has relied for centuries. Development of new products will have tremendous repercussions on international

trade. Natural products are in the main tied to localities that have the requisite climates. Synthetics, on the other hand, can usually be made wherever there is power, and from widely distributed raw materials.

Nevertheless, climatic influences will remain to be reckoned with in international trade. The cost of most food production will still be strongly affected by climate. A favorable climate increases the output-to-input ratio of any agricultural enterprise, and this naturally results in a lower cost per unit of output unless the prices paid for the inputs are abnormally high. Production of any goods tends to be concentrated in regions and nations that have especially low costs of production, because producers there can quote low prices to meet competition. Regional or national specialization and international commodity trade depend on these simple facts.

### CONTRASTING FACTOR SUPPLIES

It is common knowledge that different countries are very differently endowed with labor, useful land, capital, and mineral and energy resources. However, the extent of these differences is not so widely recognized. And the economic consequences are not so well understood.

Table 3.1 indicates some contrasting factor supplies of certain countries. The data are not all for the same year: however, with the exception of the capital estimates, they all refer to the nineteen fifties. The capital supply estimates are necessarily crude. The energy estimates depend upon a weighting of such different energy sources as petroleum, coal, and hydroelectric power. Nevertheless, despite these statistical deficiencies, a number of contrasts stand out. For example, Australia has over six hundred times the agricultural land per actively employed person as has Japan. Workers in the United Kingdom have the use of over 5 times as much capital in India. And in the United States the energy used per employed person—also a rough measure of capital investment use—is 10 times as great as in Italy.



TABLE 3.1

CONTRASTING FACTOR ENDOWMENT OF SELECTED COUNTRIES IN RECENT YEARS

	Country	Economically Active Population <sup>a</sup> (millions)	Agricultural Area <sup>b</sup> (millions of acres)	Estimated Capital Supply <sup>c</sup>	Estimated Commercial Energy <sup>d</sup> (millions of metric tons)	Agricultural Area per Worker (acres)	Capital per Worker <sup>e</sup>	Energy per Worker (metric tons)
1	Argentina	6.4	358	24	15.5	56	3.7	2.4
2	Australia	3.3	949	13	29.7	288	3.9	9.0
3	Belgium	3.5	4	10	33.0	1.1	2.8	9.4
4	Canada	5.3	151	18	101.0	28	3.4	19.0
5	Denmark	2.1	8	4	9.4	3.8	1.9	4.5
6	France	20.5	82	50	102.1	4.1	2.4	5.0
7	Germany, West	22.1	35	85	150.9	1.6	3.8	6.9
8	India	101.8	323	82	41.4	3.2	.8	.4
9	Italy	21.3	54	25	41.4	2.6	1.2	1.9
10	Japan	36.3	16	36	82.0	0.4	1.0	2.3
11	Netherlands	3.9	6	10	21.5	1.5	2.6	5.5
12	New Zealand	.7	32	3	5.1	46	4.3	7.3
13	Switzerland	2.2	5	6	11.7	2.3	2.7	5.3
14	United Kingdom	22.6	48	104	235.4	2.1	4.6	10.4
15	United States	60.0	1,118	220	1,267.4	19	3.7	21.1

<sup>a</sup> SOURCE: International Labor Organization, *Year Book of Statistics*, 1955.

<sup>b</sup> Includes crop land, orchards and gardens, temporarily fallow land, meadows and pastures. SOURCE: United Nations, Food and Agricultural Organization, *Year Book of Food and Agricultural Statistics*, 1955.

<sup>c</sup> Territorial definitions do not always exactly coincide. Estimates refer to prewar years. They are in billions of "international units." SOURCE: Colin Clark, *The Economics of 1960*, 2nd Ed., London: Macmillan & Co. Ltd., 1951.

<sup>d</sup> Refers to inland commercial consumption of fuels (including petroleum products but excluding peat) and water-power converted to coal equivalents. SOURCE: United Nations, *Statistical Year Book*, 1954.

<sup>e</sup> Millions of Clarkian "international units."

Figure 3.1, which is based on Table 3.1, illustrates these differences. The vertical axis represents agricultural acreage per economically active person and the horizontal axis represents the commercial energy consumption (in equivalent metric tons of coal) per worker. The countries located towards the axis are short of land and low on energy per worker and tend to have low standards of living.

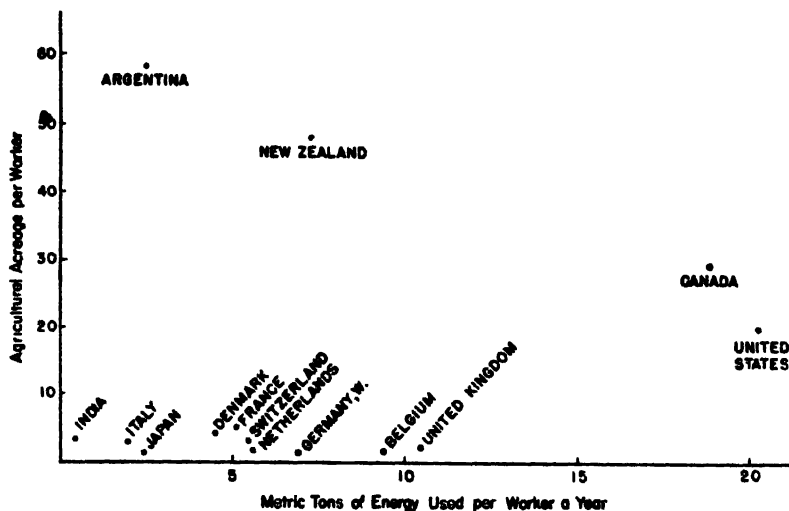


Figure 3.1. International comparison of land and energy resources available or used per worker in recent years.

It may be helpful, using the table to distinguish between those countries that are long on labor, long on agricultural land, and long on energy use (a rough measure of capital), to make a three-way classification on these lines:

<i>Long on Labor</i>	<i>Long on Land</i>	<i>Long on Energy</i>
India	Argentina	Canada
Italy	Australia	United States
Japan	New Zealand	

Among the European countries, all of which are short on land relative to labor, the United Kingdom, Belgium, and Germany make rather more use of energy per worker.

These differences among nations are important because economic theory and observation tell us that countries will normally specialize in production, and exchange their surpluses, when the different kinds of productive factors are available in each country in markedly different proportions.

The reasoning is as follows. The remuneration of each factor in each country depends upon the proportions in which it is combined with other factors. If, in the country as a whole, there is a

very limited amount of labor relative to land and capital, each extra worker has considerable value as his employment will markedly increase physical output. Conversely, if a lot of land is already being used with labor, the use of an additional acre will add little to output. Under these circumstances labor will earn high wages (and employers will use it sparingly) while land will earn low rents (and be used lavishly).

However, while it is possible somewhat to vary the proportions in which different factors of production are employed in a given industry, there are limits on the extent to which land and capital can be substituted for one another or for labor. There are some manufactures, such as making lace handkerchiefs, which tend to be labor intensive even though considerable efforts may be taken in high wage countries to substitute machinery for hands. And there are other kinds of production, such as the refining of petroleum, that must use a great deal of plant and equipment even though in low-wage countries efforts will be made to use more labor instead of capital wherever possible.

To some extent climate influences the proportions in which labor and capital can be combined in agriculture. In tropical climates, characterized by rain and sun, the damp heat makes for rapid vegetation growth. Very high yields are possible per acre and in fact considerable labor is often needed per acre to rid the land of weeds. Also, in more temperate zones, the amount of precipitation often determines whether land is used for crops or grazing, and this in turn determines whether more or less labor must be combined with the used land. Finally, where there is plenty of hot sun, but little rainfall, large capital investments may be needed for irrigation.

With these thoughts in mind it is interesting to examine the extent of the national geographic specialization that does exist in the case of commodity production. Table 3.2 lists a number of the more important products in international trade and shows the contribution of some of the major exporting countries to world exports. The percentage figures appearing in the last column indicate the importance of this commodity export to the aggregate value of the

TABLE 3.2  
NATIONAL SPECIALIZATION IN TRADED COMMODITIES

<i>Commodity</i>	<i>Exporting Country</i>	<i>Per Cent of World Trade in Commodity</i>	<i>Exported Com- modity as Per Cent of Country's Total Exports</i>
Petroleum	Venezuela	44	95
	Saudi Arabia	18	87
	Kuwait	17	100
Cotton	United States	42	6
	Egypt	17	87
	Pakistan	13	49
Coffee	Brazil	52	74
Wheat	United States	52	6
	Canada	41	17
	Australia	7	13
Newsprint and Wood Pulp	Canada	51	7
	Sweden	25	9
	Other Scandinavia	24	—
Wool	Australia	58	48
	New Zealand	16	34
	Union of S. Africa	14	20
Rubber (natural)	Malaya	40	48
	Indonesia	38	44
	Ceylon	7	25
Sugar	Cuba	67	85
	Philippines	10	26
	Dominican Republic	6	50
Copper	Chile	37	63
	Rhodesia	26	87
	Canada	11	2
Rice	Thailand	33	85
	Burma	26	26
	United States	24	1
Tin	Malaya	35	13
Butter	New Zealand	41	23
	Denmark	30	13
	Netherlands	18	3
Tea	India	46	14
	Ceylon	41	48

SOURCE: *International Financial Statistics*, February, 1956.

exports of that country. One can see, then, that countries like Venezuela, Cuba, Egypt, and Rhodesia, to mention a few conspicuous examples, tend to be "one-product countries"; that is to say, over half of their total exports in value terms come from the sale abroad of a single commodity. Obviously the economies of these countries are extremely vulnerable to fluctuating prices for the commodity in which they specialize.

The occupational "break-down" of the labor force is a further manifestation of national specialization and is a reflection of the comparative availability of productive factors in the home economy. Thus, Table 3.3, including those countries already considered in Table 3.1, shows the percentage of the economically active population engaged in Agriculture (which includes forestry and fishing), Manufacturing (which includes handicrafts), Commerce, and

TABLE 3.3  
MAJOR OCCUPATIONS OF ACTIVE POPULATION IN SELECTED COUNTRIES

Country	Economically Active Population (millions)	Percentage Employment by Major Occupations			
		Agriculture, Forestry, Fishing, etc.	Manufacturing	Commerce	Services
Argentina	6.4	25	22	13	22
Australia*	3.2	16	25	15	18
Belgium	3.5	12	38	13	—
Canada	5.3	19	26	16	19
Denmark*	2.1	25	26	14	20
Egypt	6.7	66	11	9	—
France	20.5	37	22	12	13
Germany, West*	22.1	23	31	10	17
India	101.8	70	9	6	11
Italy	21.3	40	20	10	13
Japan	36.3	47	16	12	13
Netherlands*	3.9	19	24	14	20
New Zealand*	.7	18	24	16	19
Norway	1.4	26	26	11	16
Switzerland	2.2	16	38	12	—
United Kingdom	22.6	3	37	14	23
United States*	60.0	12	27	18	22

\* Countries using International Standard Industrial Classification.

SOURCE: International Labor Organization, *Year Book of Statistics*, 1955.

Services. (This is not an exhaustive break-down, as Construction, Mining, and Transport are excluded.)

One way in which this table can be used is to see what countries have more people engaged in Agriculture than in Industry; the division of countries on these lines is as follows:

<i>Agricultural</i>	<i>Manufacturing</i>
Argentina	Australia
Egypt	Belgium
France	Canada
India	Germany
Italy	Netherlands
Japan	New Zealand
	Switzerland
	United Kingdom
	United States

Because countries like Australia and Canada have very large exports of farm products it is often forgotten that a larger percentage of their gainfully employed are in Manufacturing than in Agriculture. The explanation is that these countries, having high land to labor ratios and access to plenty of capital, attain enormous farm outputs per man-hour. Hence most of their labor forces can be released for manufacturing, commerce, and the service trades. The situation is markedly different in countries such as India. There high labor to land ratios, carrying the threat of starvation, compel a majority of the working population to labor for food. Few can be spared to provide the restaurant, laundry, cleaning, and entertainment services characteristic of the richer economies. In fact a comparison of the percentages engaged in Services and in Agriculture roughly reflects the living standards of these countries. The countries with the three highest ratios are the United Kingdom, the United States, and Canada: those with the three lowest ratios are apparently India, Egypt, and Japan.

### MINIMIZING TRANSPORTATION COST

Geographic specialization, especially in the processing and manufacturing trades, is also the result of the similar decisions of different producers regarding the location of their plants. Plants tend to

be so located as to minimize total transportation costs. This is particularly true of goods that are heavy or bulky relative to their value.

For example, steel makers need coal and iron ore. Unfortunately, in the United States these raw materials are not found together in the same locality, and the main consuming market for steel is usually located somewhere else. Should steel makers locate over the iron ore and ship in the coal? Or should they transport the iron ore to the coal deposits? Or should they locate near the steel market and transport both coal and iron ore? The situation is somewhat like a tug of war, with the steel plant in the middle and the factor sites and the final market exerting pulls in different directions.

The steel industry has tended to orient itself to its fuel supply. This is because coal is a *weight-losing* rather than a *weight-saving* factor, whereas iron ore is the reverse. The entire tonnage of coal necessary for iron and steel production is used up on the spot. In the case of iron ore, however, over a half of the iron-ore tonnage is retained to become steel later. Thus, the most economical solution is to locate the steel plants near the coal, and so avoid all or nearly all transportation cost on account of fuel. On the other hand, location near the iron-ore deposits would save only one third of the freight bill for ore. The steel industry in the United States therefore located initially around Pittsburgh, near good coal deposits.

The steel industry has naturally located itself with regard to those necessary factors that are found only in a few places. Conversely, location has not been determined by ubiquitous factors. Hence, labor supply has played a relatively small part in determining the industry's location.

Two important rules can be deduced from the above illustration. The dominant factors in determining location are those that are uniquely distributed and weight-losing, whereas the subordinate factors are ubiquitously distributed and weight-saving. The location of much of the world's industry and the geographic specialization to which it gives rise can be explained by these two connected rules.

In the following chapter it is explained how international movement of factors can be a partial substitute for commodity trade. The

kind of trade actually occurring is largely determined by transportation cost, which in turn often leads to a consideration of how weight-losing different goods are at various stages of production. An example may clarify this. Many of the doors in British homes are made out of wood taken from western Canadian trees. This wood might be transported from Canada to Britain in the form of logs fresh from the forests, sawn lumber, or in the form of manufactured doors. In practice logs are never shipped, not only because they are hard to stow on board ship but because so much of the weight goes to waste when sawed at the mill. Finished doors are the most weight-saving and are often shipped even though they bear a higher freight rate per 100 pounds. There is also some trade in lumber. The rule is that intermediate goods tend to be processed where they originate if they are very weight-losing in production. Generally, goods are most weight-losing at the earliest stages of manufacture. They become more weight-saving each time they are reprocessed.

However, processing may be done close to the final consuming market and far away from the source of the raw material when the latter is highly weight-saving. A large proportion of the petroleum products sold throughout the northeast United States is refined on the New Jersey shoreline out of crude petroleum imported from the Gulf ports and Venezuela. Almost nothing is lost from a barrel of crude petroleum; what cannot be made into gasoline, Diesel oil, or bunker fuel will emerge as kerosene, asphalt, or petroleum coke, or will be changed into lubricating oil, petroleum jelly, etc. Also, when specialized carrying facilities have to be devised, it is cheaper to transport crude petroleum alone than its many products.

Another element that must be considered is that the freight rates charged by public carriers tend to be based on the value of the goods transported. Finished goods are more valuable per unit weight, partly because more labor has been invested in them, and they usually move at higher freight rates per 100 pounds. In addition, finished goods (such as furniture or chinaware) may be more liable to spoilage or breakage than their prime constituents (for example, lumber and kaolin), and this greater risk is reflected in higher transportation costs.



Locations of industrial plants are generally chosen with an eye to transportation costs. Numerous productive agents have to be assembled from different places, and the principal and secondary products have to be shipped to one or more markets. Some single location will presumably reduce to a minimum the total freight bill. The majority of competitors in the same trade will be faced with the same problem and, after taking into account product prices and freight rates, will often reach the same decision concerning the best location. The result is geographic specialization, which in turn often causes international trade.

### **MISCELLANEOUS BASES OF GEOGRAPHIC SPECIALIZATION**

There are a number of other determinants of industrial location that deserve mention.

#### **MASS-PRODUCTION ECONOMIES**

In many lines of manufacture volume production makes it possible to use equipment and techniques that permit lower unit costs. Volume production per plant or firm normally requires a large market. For this reason industries capable of mass-production economies are normally found in those countries that comprise large enough markets to ensure a high volume of output. Accordingly, automobile and aircraft factories are located in nations having a large domestic market, such as the United States. The opposite possibility, location in a smaller nation while supplying other larger nations, has a limited practicability because a very much larger percentage of the sales would be subject to international transportation costs or customs duties.

#### **STRENGTH OF THE MARKET**

Some goods, and even more services, are of an extremely rare type which the ordinary person either does not want or cannot

afford. Expensive gadgets, of little functional use but having some novelty appeal, are throughout the world a characteristic of regions or nations having high rather than low incomes. Commercial orchid-raising within the temperate zone is an example. The best designers of sailing yachts are found in the northeastern United States and in Britain. Specialty services and products are usually found only where the national market is strong either in the sense that there is a dense population (so that there are enough fastidious people to constitute an adequate clientele) or that there are a number of extraordinarily rich people (who can gratify whims which a person of average means cannot afford).

#### ECONOMIC SYMBIOSIS

In economic life there are various enterprises that depend in part on others for their own continued existence. Such relationships are rather analogous to symbiotic parasitism in biology. A few examples of leading types may breathe life into this concept.

*Externally Conditioned Labor.* Different industries often give supplementary support to the same group of workers or their families. For example, the logging industry of Canada operates and pays wages only in the summer. So in the wintertime many loggers are employed by railroads in maintaining their right of way. This arrangement benefits both the logging companies and the railroads. Each would be compelled, if the alternative employment did not exist, to pay a wage that could support the worker throughout the year. The economies which such seasonal complementarity provide are sometimes an important determinant of geographic specialization.

Heavy industries, such as coal mining and steel making, employ strong men rather than women and girls. However, the employed men are often heads of families that include the normal proportion of females. Most of these women, and almost all the unmarried ones, will seek employment unless the head of the family is earning abnormally good wages. In the past a region of heavy industry such

as mining has attracted a light industry such as textiles to the same locality because of the abundant female labor obtainable at low wages.

*By-products.* The making of many goods yields by-products which can be obtained cheaply by subsidiary industries that are able to use them. Meat packing gives rise to a host of related industries that are dependent upon its by-products. Examples are gluemaking from hooves, fertilizer manufacture from bone, and leathermaking from hides. In such cases regional or national specialization in the main products leads to regional or national specialization in the by-products.

### CONCLUSIONS

Nations will normally specialize in those goods that producers can sell cheaply; ability to quote low prices is largely based on low unit costs of production.

A region or nation will have low unit costs in producing a specific good if (1) the output-to-input ratio is very high, (2) the inputs are low-priced, or (3) the total transportation bill from all input sources to the enterprise, and then on to the consumers, is low. The importance of climate, especially in agriculture, lies in the fact that it largely determines the ratio of output to input. Given a certain output-over-input relationship, it is obvious that costs per unit of output will depend on the price of inputs. Factors of production are priced according to the relative strength of demand and supply. In general the per capita demand for specific factors does not vary considerably from region to region or from nation to nation because people everywhere have somewhat similar wants and needs. The variation in factor prices, which is often so apparent among regions or nations, must therefore be in large measure due to differences in their supply. Finally, joint-demand factors may be located in different regions or nations, and in this case a compromise location in some one region or nation will be selected in order to minimize all transportation costs per unit of output.

As a rule, it can be said that there would be very little interna-

tional trade if all countries possessed the various factors of production in approximately the same proportions. Alternatively, even if the ratios of land and capital to labor differed among countries, there would not be much international trade if these factors could be substituted for one another at will. Conversely, if in every country it were only possible to produce each commodity in one way, thereby using productive factors in similar proportions, many countries would import *all* their supplies of certain goods. If transportation costs were nil, national specialization would be complete, given disproportionate factor endowments. Actually, international trade continues despite the ingenious substitution of factors by producers, despite transportation costs, and despite the willingness of local consumers to modify somewhat their way of living to suit the national endowment.

### PROBLEMS

1. "Climate can have little influence on national specialization because it in no way affects the relative availability of labor, capital, land or other productive factors." *Evaluate.*
2. "Eventually science will so increase our technical ability to substitute one factor for another, in any line of production, that most international trade as we know it today will disappear." *Evaluate.*
3. "It is rather paradoxical that the countries having the lowest food intake have the most people engaged in agriculture." *Explain.*
4. "Refrigerated transport has made the fortunes of many countries far removed from the world's food markets." *Exemplify.*
5. "It is uncertain whether international trade exists more because of differences in national consumer tastes or differences in national factor endowment." *Evaluate.*



# Factor Movements and International Trade

A thorough understanding of international economics requires some appreciation of the interaction between trade in products and the movements of labor and capital among nations. It is hoped that the following analysis will indicate the relations between trade, immigration, and international lending policies. An attempt will also be made to identify the special interests of labor, land-owners, and lenders in so far as they are affected by international trade and factor movements.

## THE EFFECT OF TRADE ON FACTOR REWARDS

Our exploration will begin with two countries, "Australasia" and "Holland," producing two products, meat and vegetables, with two factors, land and labor. Australasia has a high land to labor ratio whereas Holland has a high labor to land ratio. We shall assume that meat production requires a comparatively large amount of land and vegetable growing needs a relatively large labor force. What would be the situation in these two countries, especially as regards the use and rewards of these two factors, if (1) there was a complete embargo on trade, and (2) there was free trade, with and without transportation costs?

## A COMPLETE TRADE EMBARGO

*Australasia.* In Australasia the diet will run to meat *father* than to vegetables simply because of the relative abundance of meat and scarcity of vegetables. In fact, consumers will become so tired of this extraordinary diet that they will pay only a low price for meat, whereas the rarity of vegetables will cause people to pay a high price for them (upper diagrams, Fig. 4.1). Fundamentally, this state of affairs results from abundant land and scarcity of labor coupled with the fact that meat production requires more land than labor.

## AUSTRALASIA

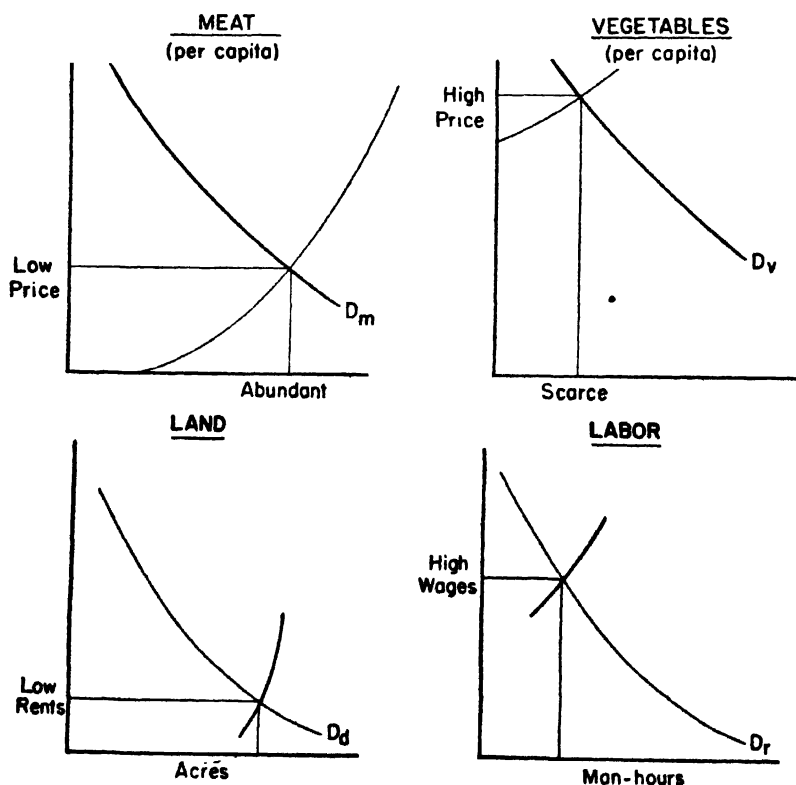


Figure 4.1

The price (or rent) of land will be abnormally low in Australasia whereas the price (or wage) of labor will be exceptionally high.

Let us assume that the land is of uniform quality. The supply schedule for land is almost inelastic and lies far to the right. The demand schedule for land is based on two elements. One is the demand for the things that land helps to make—that is, meat and vegetables. The other element is the physical productivity of an extra acre of land in making these final consumption goods. When finished goods are sold under conditions of pure competition, the demand for land, or any other factor, is based on its marginal physical product times the price of a unit of output.

The marginal physical product varies according to the principle of variable proportions. This is an exceedingly important element of economic theory. In any enterprise various factors of production are combined together. Perhaps a little labor will be combined with a great deal of land (for example, four workers to 3,000 acres) or a great deal of labor combined with a small area of land (120 workers to 15 acres). The addition or subtraction of a worker will have a much greater effect on physical output in the first case than in the second. On the other hand the addition or subtraction of an acre of land would hardly be noticed in the first case, but would significantly alter production in the second. (This is similar to the situation at a dance where there are a great many girls and very few men. The arrival of an extra man will really contribute to the success of the dance, but it will not make much difference if one of the girls goes home.) The rule is that in any given line of production the marginal physical product of one factor becomes greater when it is combined in smaller proportions with other factors.

The rent of an acre of land in Australasia is low. Enough labor to work an extra acre adequately is just not to be had. Moreover, most of the demand for land comes from the demand for meat, and the price of meat is very low.

We can now consider the labor market in Australasia. In the main the supply schedule is high and to the left in recognition of this nation's small population (lower right diagram, Fig. 4.1). Employers are willing to pay high wages because (1) labor is always



combined in such low proportions with land that its marginal physical productivity is high; and (2) most of the demand for labor is derived from the demand for vegetables, which are selling at abnormally high prices.

*Holland.* The situation in Holland could be represented in a separate figure. Demand schedules for meat and vegetables, although the same per capita, would lie to the right because of the relatively large population. The supply schedule for land would lie to the left, and that for labor to the right, as compared with Australasia. The meat-supply schedule would tend to lie to the left because of the relative scarcity of land; and the vegetable-supply schedule to the right, because of the comparative abundance of labor. As a consequence in Holland one eats mostly vegetables, with meat on the side, rather than the other way around. Meat prices are high and this serves both to ration the limited supplies and to encourage increased production. Vegetable prices are low.

Land rents are high in Holland. In part this is due to the relatively small supply. High land rents are also based on the fact that an extra acre of land is worth a great deal to any farmer or rancher in this area. Land has a high marginal physical output because it is always combined in relatively small proportions with labor.

Wage rates will be low in Holland. An extra man is of relatively little worth to a farmer or a rancher because an additional laborer can be given only a small amount of land to work. Also, the major demand for labor is derived from the demand for vegetables rather than for meat, and vegetable prices in Holland are very low.

*Allocation of Factors among Uses.* Farmers and ranchers will both be competing for the use of land, so it is necessary to understand how land is theoretically apportioned between the two uses of vegetable-growing and meat production. The individual agriculturalist has no direct control over the rent of land: he simply accepts the going land price as one of the facts of economic life and adjusts the quantity of land he uses accordingly. If the rent of land falls, a rancher will seek the use of extra acres until the last piece is worth no more to him than its price. This marginal worth refers to the extra total revenue attributable to working an additional acre.

When the output is sold under conditions of pure competition, the marginal worth can be calculated by multiplying the marginal physical product by the price at which each unit of output is sold.

If the price of meat goes up, this increases the marginal worth of land to ranchers and they will seek to acquire more. In doing so they will bid up the rent of land slightly. This will force vegetable farmers to relinquish some land so that the marginal *physical* product of land in vegetables will rise until the marginal *worth* of such land is equal to the new rents. On the other hand, a drop in the price of vegetables would also transfer the use of land from farmers to ranchers.

Labor is apportioned between farmers and ranchers in the same way, wages being equal in both employments, and marginal physical products in farming and ranching being in inverse ratio to the prices of vegetables and meat.

#### FREE TRADE WITHOUT TRANSPORTATION COSTS

We will now study some of the repercussions that would occur if these two national economies became connected by commodity trade. We will provisionally assume that there is no cost for transporting goods and that there are no import or export obstructions. We will ignore monetary problems, suppose that each nation uses the same currency, and assume that central-bank policy is identical in both.

*Exports and Imports.* Australasia and Holland comprise a single market if there are no transportation or legal costs in moving commodities. The result will be a uniform price for meat and vegetables in both regions. This price equality is brought about by imports and exports, and these in turn are caused by the price discrepancies that would otherwise exist.

Figure 4.2 depicts what happens to meat after the advent of free trade. The two national markets have been arranged back to back. The horizontal scale reads from right to left for Australasia (the left-hand side of the diagram) and from left to right for Holland (the right-hand side of the diagram). The demand curve

for Holland is flatter because of the greater consuming population. The supply schedule commences at a much lower price in Australasia, primarily because of the low land rent.

However, these two nations now comprise a single meat market, and so the combined demand must equal the combined supply. At the equilibrium price the horizontal distance representing exports must equal the horizontal distance representing imports. At this equilibrium price of  $OC$  Australasia produces  $AC$  quantity

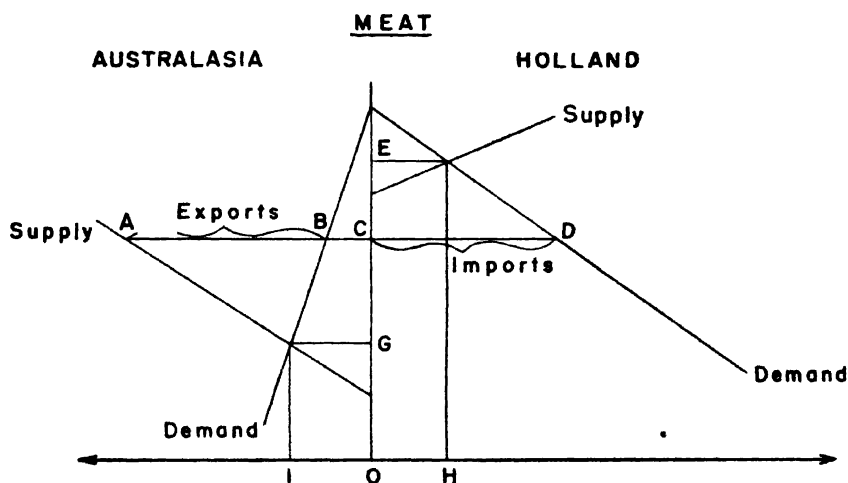


Figure 4.2

of meat, but consumes only  $BC$  and hence exports the difference, which is  $AB$ . Holland consumes  $CD$  and produces nothing at this price, so Holland must import its entire consumption.

What is the dietetic outcome of all these happenings? The people of Holland are delighted to find that the price of meat has fallen from  $OE$  to  $OC$ , and so they increase their consumption from  $OH$  to  $CD$ . The residents of Australasia find that the Dutch demand has raised their meat prices from  $OG$  to  $OC$ , and they economize on meat by eating only  $BC$  instead of  $OI$ . Meanwhile analogous developments are occurring in the vegetable market, for there is now a flow of vegetables from Holland to Australasia which

equalizes vegetable prices in both regions. Consequently, more vegetables are eaten "down under" and fewer in Holland. Both populations now enjoy a better-balanced diet than before. This is an important benefit derived from this example of international trade.

*Recombination of Factors.* In the extremely simple case assumed here, all the meat production will take place in Australasia, and all the vegetable-growing will be done in Holland. This specialization will decrease the ratio of land to labor employed by ranchers in Australasia because the ranchers now have the use of the land and labor formerly used in vegetable farming, and vegetable farming was always marked by intensive labor use. On the other hand, there will be an increase in the ratio of land to labor employed by vegetable farmers in Holland, for a relatively large amount of land and a small amount of labor has now been released from ranching. The arithmetic which underlies these statements is exemplified in Table 4.1.

TABLE 4.1  
COMBINATION OF FACTORS—RATIO OF LAND TO LABOR

<i>Australasia</i>		<i>Holland</i>	
Number	Ratio	Number	Ratio
BEFORE			
120 thousand ranches	6,000 acres to 2 workers on each	110 thousand ranches	300 acres to 4 workers on each
80 thousand farms	40 acres to 3 workers on each	190 thousand farms	5 acres to 7 workers on each
AFTER			
200 thousand ranches	average of 3,616 acres to 2.5 workers on each	300 thousand farms	average of 113 acres to 5.9 workers on each

*Changed Factor Prices and Quantities.* The sudden rise of a large trade flow between two regions or nations is likely to change factor prices very considerably. In the present case land rents will certainly rise in Australasia and may fall in Holland; labor wages may fall in Australasia and will certainly rise in Holland. The

common sense of this is apparent. Land in Australasia, which seemed relatively abundant when that region constituted a separate nation, takes on a scarcity value when the two areas are merged into a single unit. On the other hand, the land in Holland must now compete with the less highly prized land of Australasia. Conversely, Australasian labor must face the competition of workers in Holland, who are benefited by the comparative labor scarcity in Australasia.

This process needs to be traced more precisely. The collective-demand schedule for land in Australasia was the aggregate of the individual-demand schedules of ranchers only. (The geographic specialization is so complete under our assumption of no freight costs that all the ranchers were in Australasia and all the farmers were in Holland.) A rancher's individual-demand schedule for land is based on the marginal worth to him of each successive unit employed. Now the rent of land must go up if the marginal value product has increased for all ranchers. This is undoubtedly higher now because both the marginal physical product of land in ranching *and* the price of meat are higher than before. The fact that less land is now combined with each worker in ranching enhances the marginal physical product and the consumers of Holland have increased the price of meat in Australasia. Consequently, the demand schedule for land in Australasia is shifted upwards. This results in an intersection with the land-supply schedule at a higher rent.

The labor wage in Australasia may fall or rise. Two opposing forces are at work. The collective-demand schedule for labor in this nation is based now on the marginal worth of labor in meat production only, which equals the price of meat times the marginal physical product of labor in ranching. Because of the increased labor to land ratio now found on Australasian ranches, it follows that the marginal physical product of labor in raising meat must be lower than before; however meat prices are higher because of the strong demand for Australasian meat by the Holland market. The over-all demand for labor in Australasia will only rise (as will wages) if the percentage reduction in marginal physical

productivity is less than the percentage increase in meat prices.

The situation in Holland can be passed over quickly. Labor wages must be augmented because both the marginal physical product of labor in farming *and* the price of vegetables will rise. Land rents will rise if the reduction in the marginal physical product of land in farming is proportionately less than the increase in vegetable prices.

Parenthetically, it is worth noting that these changed prices for factors appear to accentuate the inequalities previously existing between the two nations' *supplies* of factors. Holland was always long on labor supply. Now that wages have increased, employees may work longer and a larger fraction of the population may seek jobs. If land rents fall in Holland, the public may transfer some areas from production to parks, thus further reducing the already small land supply. Reverse developments may occur in Australasia.

The general effect of free trade is to eliminate price differences between the nations for any one factor. This elimination is effected principally by a price increase in the nation where the particular factor was abnormally cheap before. This *may* be supplemented by a price reduction in the nation where the same factor was formerly at a premium. For example, land rents certainly rise in Australasia, *but* do not necessarily fall in Holland. Land rents in Australasia will only stay below those in Holland if the existence of transportation costs prevents commodity price equality. International trade tends to eliminate rent or wage inequalities, just as merchandise trade tends to eliminate differences in meat prices or vegetable prices.

The effect of free trade on factor prices is naturally of tremendous political importance. Landowners in Holland fear that freer trade will reduce rents, and hence their incomes. But workers in Holland should welcome freer trade with Australasia, as this gives them a novel scarcity value. Accordingly, there may be a conflict between different groups within Holland over trade policy. However, there should be no such conflict between the people of Holland as a whole and those of Australasia. Policy clashes should, rationally speaking, be intranational rather than international.

**PARTIALLY OBSTRUCTED TRADE**

Normally it costs money to transport goods from one nation to another. Not only are there freight charges but there may also be spoilage losses. In this case the price of vegetables will be higher in Australasia than in Holland by the total transfer cost of vegetables per unit; for example, if the transfer cost of vegetables is 28¢ per pound, the price in Holland will be this amount below the Australasia quotation.

If the price differential occasioned by transfer costs reaches a certain magnitude, geographic specialization will be partial rather than complete. Imports will be supplemented by home production. Australasia will start growing some vegetables or Holland will engage in limited meat production. For example, as the price of vegetables falls and the price of meat rises in Holland, it finally happens that the marginal physical product of labor in meat output times the price of meat becomes equal to the marginal physical product of labor in vegetable output times the price of vegetables. Similarly, the marginal worth of land in meat may rise to that in vegetable production. Meat production begins in Holland when this occurs.

Other partial obstructions to trade, such as tariffs, have the same effect as freight costs. There will then not be perfect price equality among nations for commodities. Geographic specialization will not be complete because home production will supplement imports.

**SOME EFFECTS OF LABOR MIGRATION ON TRADE**

It is interesting to speculate on the possible consequences of immigration in this situation. In actual life many factors—except land—are relatively mobile in the long run. Migrations of workers to a new country do occur, whether to escape unemployment or to obtain higher wages.

If workers and their families considered only their economic advantage, and ignored all the psychological deterrents incidental

to changing jobs and nationalities, what would happen to commodity trade and factor earnings? In the extreme case of no moving cost to the workers—due perhaps to government subsidized migration—one might conceive of a transfer of labor and people from Holland to Australasia until real wages were the same in each country. If land were everywhere homogeneous and everything else was also equal, one can conceive of labor and land being combined in exactly the same proportions in meat production in both countries. Vegetable farming would then be carried on in the same way in both countries. There would presumably be no international trade between Holland and Australasia in either meat or vegetables, whether or not these commodities are shipped free of freight charges. Immigration, once completed, will have removed any stimulus to commodity trade. Naturally this migration will be bitterly resented by native workers in Australasia and by landowners in Holland.

This theoretical outcome is rather far fetched; it rests on unrealistic premises. International movements of labor do occasion costs, both monetary and psychic, for the migrants. Australasian "land" will have different ranching and farming potentialities than Dutch "land." Differences in climate alone will lead to dissimilar combinations of labor and land in both countries, whether for meat ranching or vegetable farming. Moreover, because of transport costs, meat will normally sell at a lower price, and vegetables at a higher price, in Australasia than in Holland. For all these reasons we cannot expect that unrestricted immigration will exactly equalize labor earnings, or land rents for that matter, in the two countries. However, to the extent that it does reduce wage differences and rent differences, migration will contract commodity trade.

Realistically, labor is combined not with a single factor, "land," but with many factors. Even "land" is not a homogeneous factor, by any means: there is grazing land, arable land, forest land, coal land, iron ore land, and so on. What would happen in the case of Australasia and Holland if we assumed that *each* country had a stock of vegetable farming land and of meat grazing land and



that neither kind of land could be economically used in producing the other food product?

In this case, supposing transport costs and various inertias, immigration will not equalize wage rates in the two countries. (Obviously, in either country, it is still true that workers should get the same wage whether helping to produce meat or vegetables.) Moreover, in Australasia, the rent per acre of farming land will equal the rent of ranch land only by accident. Similarly, there will be two different land rents in Holland. Once again immigration has probably injured Australasian labor and Dutch landowning interests.

Now let us suppose that gold is discovered in Australasia. There will be an additional derived demand for labor in that country and wage rates will rise. Less labor will be combined with land in both vegetable and meat production so that the marginal physical product of land—and consequently rents also—will decline. The supply of meat and vegetables will decline slightly and Australasia will tend to export somewhat less meat and import somewhat more vegetables. However, there will now be some gold exports to settle the net unfavorable trade balance on these other two commodities. Eventually the higher wage rates, instigated by the gold discoveries, will bring more immigrants to Australasia, to the satisfaction of its landowners.

There is little doubt but that, except perhaps in pioneer days, immigration to any country, and especially to a high-wage country, will tend to lower earnings per worker there. If labor unions sometimes lobby to prevent the importation of goods from low-wage countries they can certainly be counted upon to oppose any large-scale immigration of labor. From a selfish viewpoint they are well justified in agitating against such immigration. What is in the national interest is another matter.

### INTERNATIONAL CAPITAL MOVEMENTS

It is now time to consider an additional factor—capital—but only after provisionally defining the term. By capital, in this con-

nection, we do *not* mean produced means of production, such as engines, lathes, and farm tractors. We mean capital funds that are lent in exchange for some evidence of indebtedness and for productive purposes.

Reverting to our example, it is probable that capital will flow from Holland to Australasia, in the course of the latter's development. This capital movement will be in response to higher interest rates in Australasia. (If lenders believe Australasian loans are especially risky, interest rates will differ considerably.) Most "new" countries initially lack both labor and capital, relative to land availability, and since the inward flow of population and labor increases the marginal physical product of capital, the interest rates that ranchers, farmers, and others can afford to pay are raised. Again, this "short supply" factor will be welcomed in Australasia by all save those who provide it there, for its increased availability will sustain or augment labor wages and land rents.

The spending of these borrowed funds by Australasians will affect the trade balance. To the extent that they are spent for *imported* engines, lathes, and farm tractors, etc., there will be a temporary worsening of the merchandise trade balance, even though the production of vegetables and the export of meat remain unchanged. To the extent that these borrowed funds are spent *domestically*, however, on home produced means of production, there will be a diversion of labor, and land perhaps, from ranching and farming: meat exports will fall, vegetable imports will rise, and the trade balance becomes temporarily "unfavorable." Hence capital transfers, as compared with labor transfers, have a comparatively direct and immediate impact on commodity trade flows.

### TRIANGULAR COMMODITY AND FACTOR MOVEMENTS

Let us now add an imaginary Ceylon to the problem. Ceylon has a comparative advantage in tea production and its dense population severely presses upon its land and capital resources. Holland

has a less high labor to land ratio, but a very high ratio of capital to land. Australasia continues to be "long" on land.

If there were unrestricted movement of factors, Ceylonese labor would emigrate, especially to Australasia. Dutch capital would be lent abroad to both countries and some Dutch families would move to Australasia. Australasia would export some meat, Holland some vegetables, and Ceylon some tea. Moreover, Holland would probably export some if not all of its capital loans in the form of capital goods. These various factor movements would reduce factor price inequalities and thereby contract commodity trade to some extent.

However, we can expect the Australasian government, for racial and other reasons, to exclude immigrants from Ceylon. Holland will probably do the same. The only methods remaining to the Ceylonese to raise labor productivity in their country are either to control population growth or to invest productively. As the standard of living is very low in Ceylon it may be impossible for the Ceylonese economy to accumulate capital goods without borrowing from abroad. Dutch capitalists, faced with low interest rates at home, will be anxious to lend money to Ceylon if they see reasonable prospects of repayment.

Any repayment by Ceylonese borrowers will have, directly or indirectly, to be through tea exports. Even the tea exported to Australasia helps to repay the Dutch loans, for the tea can be exchanged in Australasia for meat which can be sold in Holland. Hence there may be some consternation in Ceylon and Holland if Australasian *autarkists*, deciding that tea should be home grown, secure an import embargo on tea. In just such a way can one country, through restricting an import, impair the ability of two other countries to undertake useful capital transfers.

It is not hard to see how these economic policies can affect the international relations of these countries. The Ceylonese will naturally resent their exclusion from Australasia. Moreover, to the extent that the ability of Ceylon to borrow might be inhibited by Australasian embargoes on tea imports, injury will be added to insult.

### CONCLUSIONS

From our analysis of these three somewhat imaginary countries we can draw important generalizations about actual world economies. (1) International commodity trade reduces factor price inequalities among nations: it does not eliminate them, if only because of freight costs. (2) Factor movements are a partial substitute for commodity trade since they also reduce factor price inequalities: this is true even of such immobile factors as land, because the movements of *other* factors result in land being combined in more balanced proportions. (3) Capital is the most mobile factor, and capital movements take the form of merchandise trade, the borrowing nation's trade balance temporarily worsening. (4) The main conflicts of interest arising from international commodity trade occur *within* each country, the owners of some factors losing income relative to owners of other factors who gain income. (5) International labor movements may cause a more widespread conflict of interest between the countries of emigration and immigration, however.

### PROBLEMS

1. "Only under very particular assumptions will national specialization be complete with certain countries importing all their consumption." *Explain.*

2. "Cheap imports mean cheap foreign labor, otherwise they wouldn't be imported, so as a good trade union man I'm against them." *Evaluate.*

3. "Considering that land is immobile I cannot understand how economists can say that international movements—whether of products or other factors—can reduce land rent inequalities among nations." *Evaluate.*

4. "In every country there is some factor of production, the owners of which will benefit from increased international trade." *Explain.*

5. "Without foreign trade every country could produce what it wanted to consume and our diet and general way of life would be more balanced." *Evaluate.*



## **National Adjustments to a Changing World**

Constant change is one of the unchanging facts of economic life. As a consequence history is replete with instances of prospering and declining national economies. The present century has already witnessed a substantial change in the economic fortunes of the United States, Great Britain, the Netherlands, Canada, and other nations.

These shifts in the economic power of nations are largely due to "structural changes" over which governments have little if any control. New products are introduced, new demands arise, the relative importance of different markets varies, old sources of supply dwindle, colonies are lost, and industrial capacity is destroyed or created as a consequence of war. Examples of these kinds of change were given in Chapter 1.

There are other changes, however, that are the result of government action and particularly of monetary policy. A policy of credit inflation to ensure full employment will affect home prices and hence exchange rates and the balance of payments. Moreover, the commercial policy of a government, which may take the form of import embargoes or export subsidies, for example, will also compel an adjustment between the home economy and that of the world.

The economic adjustments of nations are accompanied by vari-

ous shocks and tremors just as the slow settling of the earth's crust is accompanied by large and small earthquakes. Adjustments in the world economy occur mainly through (1) domestic price changes, (2) exchange rate variations, (3) international money transfers, (4) government monetary policies, and (5) changes in central bank interest rates. Naturally these actions and consequences frequently interact, often in complicated ways; Appendix A describes the interactions of (2) and (3) above. Also, some of these adjustments (e.g., exchange rate variations) are "natural" in the sense that they will normally occur in the absence of government action. Others (e.g., a policy of credit "squeeze") are deliberate and may in fact be used for other purposes than restoring international equilibrium.

In the present chapter we shall review these various manners of adjustment. In all cases we shall suppose that governments do *not* prevent the occurrence of natural adjustments, but that they act to restore an efficient international equilibrium. However, practice is so often the reverse of this assumption that a special chapter follows, entitled "Controlled Disequilibrium."

### STRUCTURAL CHANGES AND MARKET PRICES

Most "structural changes" involve specific products and are reflected in shifting demand or supply conditions in importing or exporting countries. For example, let us say that Nation A normally exports copper, and that the world price is falling. This may be due to an increase in A's export supply which in turn could be due to: (1) lower costs of production in A or a reduced willingness to buy on the part of copper users in A; or (2) reduced demand by the rest of the world for A's export, which in turn could be due to an increased ability to produce copper abroad or a reduced need for copper on the part of foreign users.

A falling copper price will not alter these underlying causes but it will mitigate their consequences. Thus a lower price for copper in A will result in more domestic use of copper and less domestic production: the same outcome can be expected in other

countries that use copper or produce it. The falling price brings world demand into adjustment with world supply.

However, these desirable adjustments are most likely to occur when national markets are subsidiary parts of a world market. If each importing country is shut off from the markets of each exporting country, perhaps by import quotas or exchange controls, there is no effective world price. An efficient and automatic method of international adjustment has then been unwittingly lost or deliberately discarded.

### EXCHANGE RATE ADJUSTMENTS

It may happen that a nation, importing and exporting numerous goods, finds that its balance of trade is becoming either less "favorable" or more "unfavorable." If such a nation is on an inconvertible paper currency there is likely to be, other things being equal and assuming no government interference, a depreciation in the foreign valuation of its money. This may be because foreigners (buying fewer of the country's exports) will need less of its money.

Let us suppose that sterling has depreciated 25 per cent, so that roughly it now takes £.360 instead of £.288 to buy a United States dollar. The fundamental problem is then whether aggregate sterling earnings from all exports will increase sufficiently at the new rate, relative to aggregate sterling outlays for all imports, so that the balance of trade gap is either closed or can be readily financed by other income from abroad. For this to happen there will have to be a considerable physical quantity increase of exports and/or decrease in imports. If there is no change in physical quantities traded, depreciation will only have made imports more expensive and exports less valuable in terms of sterling, and the trade balance will deteriorate further.

In order to clarify matters let us first examine the possible effect of depreciation on a sterling country's wheat imports and coal exports and then consider what has been happening to other imports and exports. A new foreign exchange rate will then compel a



fundamental adjustment in the quantities, prices, and aggregate values of *all* imports and exports. These changes may well have a different incidence on different social classes at home and so devaluation as a means of countering balance of payments deficits may prove to be an important political issue.

#### THE THEORY OF ADJUSTMENT VIA EXCHANGE RATE VARIATION

First we should understand what sort of changes in the demand or supply of exports or imports may bring about a state of affairs in which a nation is less able to pay for imports with its exports. Table 5.1 provides this information for goods sold competitively. All references to changes in demand or supply are at a given price in the country in question.

TABLE 5.1

#### NEW CIRCUMSTANCES THAT MAY RESULT IN AN UNFAVORABLE TRADE BALANCE FOR NATION A

##### *Exports by A*

##### *Foreign Changes*

- Decrease in foreign demand
- Increase in foreign supply

##### *Domestic Changes*

*If foreign demand for  
exports is elastic*

- Increased domestic demand
- Reduced domestic supply

*If foreign demand for  
exports is inelastic*

- Reduced domestic demand
- Increased domestic supply

##### *Imports by A*

##### *Domestic Changes*

- Increase in domestic demand
- Decrease in domestic supply

##### *Foreign Changes*

*If domestic demand for  
imports is elastic*

- Reduced foreign demand
- Increased foreign supply

*If domestic demand for  
imports is inelastic*

- Increased foreign demand
- Reduced foreign supply

For example, let us suppose that some country, like Great Britain, used to export coal and import wheat. More recently, though,

there has been a reduction in the domestic supply of coal and an increase in the domestic demand for wheat. Hence fewer credits are earned from exports, more import debits are occasioned by imports, and the trade balance worsens. Sterling presumably depreciates, in the absence of government control, in terms of leading currencies such as the dollar. Can we expect that this depreciation will lessen import debits (for wheat and all other imports) and augment export credits (for coal and all other exports), thereby righting the trade balance and stabilizing sterling, albeit at a lower dollar value? It will help to use Figure 5.1.

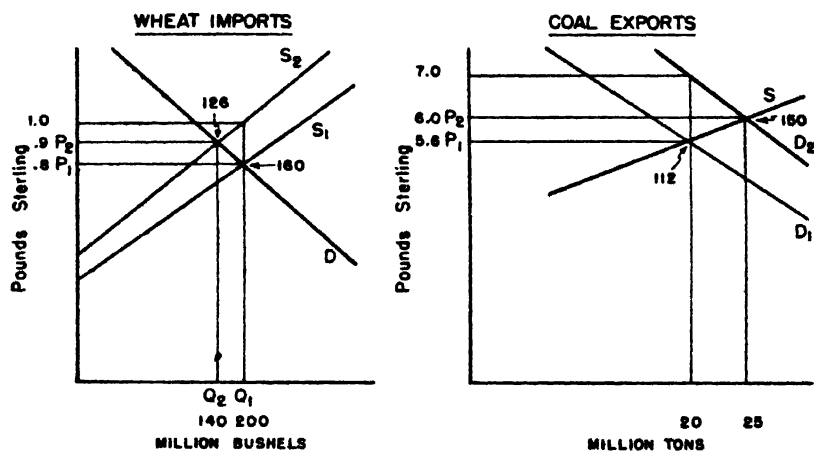


Figure 5.1

Perhaps, before depreciation, 160 million sterling of debits in the balance of payments were attributable to wheat imports (that is, 200 million bushels at 0.8 of a pound each); and 112 million sterling of credits were attributable to coal exports (20 million tons at 5.6 pounds each). One effect of the 25 per cent depreciation in sterling is to raise the entire import supply of wheat (in the left-hand diagram) and the entire export demand for coal (in the right-hand diagram) by 25 per cent in each case. If the quantity of wheat that is imported remained unchanged, these imports would occasion a 200 million pound debit at the new and higher

sterling price for wheat. Similarly, if the quantity of coal exported were unchanged, these exports would now occasion a 140 million sterling credit at the new and higher sterling price for coal. The deficit as regards these two goods alone would now be 60 million instead of 48 million sterling. That is why, if depreciation is to cure the payments gap, there must be an adequate decrease in imports and an increase in exports, say to 140 million bushels and 25 million tons respectively.

Actually, assuming that the domestic demand curve for wheat imports remains unchanged, less wheat will be imported. Also, assuming that the domestic supply curve of coal exports remains unchanged, more coal will be exported. The vital question, though, is still whether or not these changes will so alter the import debits and export credits, attributable to wheat and coal respectively, that the gap in the balance of trade will be narrowed rather than widened by depreciation. Figure 5.1 assumes they do.

The effect upon the balance of trade gap will depend very largely upon the character of the domestic demand for wheat imports and upon the domestic supply of coal exports. The final sterling price for wheat will almost certainly be higher than before depreciation. Hence, if the wheat demand is elastic, smaller sterling debits will be incurred, if the wheat demand is inelastic, larger sterling debits will occur. However, the situation regarding coal exports is less ambiguous. There will almost certainly be a higher sterling price for coal after depreciation, and this will normally increase the supply of coal exports, so that sterling credits attributable to coal can be expected to rise.

Actually there are, of course, many imports and exports besides wheat and coal. From what we have learned regarding the effect of currency depreciation on these two commodities is it possible to say much about the over-all effect upon the trade balance? Each and every export presumably is now sold abroad in greater quantities and at a higher price, so all exports presumably earn more *sterling* equivalent of foreign exchange. The *sterling* drain on account of imports, though, will only be smaller in those cases where the domestic demand for imports is elastic. This is more

likely to be the case for those imports that are both used and produced at home: an increase in their sterling price in the domestic market will then both reduce the quantity demanded *and* increase the home supply, having a double effect on the quantity imported. Hence, even though the home demand for the commodity may be inelastic, the domestic demand for *imports* may be elastic.

#### SOME SPECIAL CONSIDERATIONS

Before any national government elects to depreciate as a means of improving its country's balance of trade, there are a number of special circumstances that it should weigh carefully.

First, many exported goods comprise materials and parts that have to be imported. For instance, British woolen and cotton textiles are for the most part made from imported wool and cotton, and Canadian automobile exports constitute assemblies of parts imported from the United States. In such cases, depreciation has a much reduced effect, and the only gain in terms of local currency is in the value-added-by-manufacture element in exports.

Second, the net price received by an exporter may be considerably less, by some fairly constant amount, than the sum paid for it by a foreign buyer. The difference may represent freight, specific import duties, insurance, and so forth. Hence, the net demand schedule apparently confronting an exporter may be less elastic than the actual import demand schedules of buyers in foreign lands.

Third, creeping cost increases are to be expected in any country that depreciates. For every imported good there are usually a number of domestic goods that are partial substitutes. Being in rival supply, the prices of the domestic substitutes tend to rise, because the imported goods rise in price. Also, home-produced commodities that are in rival supply with exported goods become higher priced. Consequently the costs of domestic producers who export begin to rise. In this way the financial gains of depreciation become eroded.

Fourth, the balance of trade is only a part of the balance of

payments, and the effect of depreciation upon some of the other accounts may be untoward. For example, Great Britain for a long time received net payments of principal and interest each year, contracted and defined in pounds; hence any depreciation of sterling reduced the overseas purchasing power of this income stream from debt service. Conversely, if a newly developed country is repaying loans that are denominated in the currencies of some older or wealthier nation, then depreciation by the immature country will, at least in this regard, benefit the creditor country.

Fifth, as already indicated, depreciation *per se* cannot cure a country's balance of payments ills unless it in turn causes a reduction in the imports and an increase in the exports of that country. Here again facts must be realistically appraised. A densely populated country that has always depended upon food imports may find that there is a limit to the extent that food imports can be cut down. Also, it is not always possible to expand the production of exportable goods in great quantity. For example, following World War II, there was a limit to the quantity of cars, whiskey, and so on, that could be immediately produced in the United Kingdom, and this may have been one reason that the British Government resisted depreciation for several years following that war.

Depreciation holds more promise of balancing a nation's international payments when supply and demand curves of imports and exports tend more to the horizontal than to the vertical. Actually a nation's demand for an import will tend to be less elastic if there is no appreciable opportunity to produce substitutes at home, if the good is relatively low priced, and if the good is considered a necessity by users. Similarly, a nation's supply of an export will be less elastic if the home consumption of the good is comparatively small, if it sells at a low price, and if local producers have no profitable production alternatives. In addition, the supply elasticity of an import will be less if the importing nation purchases a large share of the aggregate world export, and the demand elasticity for an export will be less if the selling nation exports a large proportion of a commodity entering world trade. In general,

the demands and supplies of large and well-to-do nations, for both imports and exports, are less elastic than those of small and needy countries.

#### **WELFARE ASPECTS OF CURRENCY DEPRECIATION**

More fundamental aspects of currency depreciation are whether it injures or benefits a country and whether certain groups within the country gain while other groups lose.

In the above example, depreciation increased the quantity of coal exported and reduced the quantity of wheat imported. The aggregate barter terms of trade moved against the country, in the sense that fewer bushels of wheat could be obtained in exchange for a ton of coal. Depreciation can only record a lowering of the national economic welfare, although it may benefit certain special interests.

Superficially, it is depreciation that appears to render the barter terms of trade less favorable. Fundamentally, the barter terms of trade become less favorable when a nation comes to want imports more urgently or the world comes to want a nation's exports less imperatively. The exchange rate is a link between the basic cause (a change in the comparative demand of nations for each other's goods) and the significant result (a change in the aggregate barter terms of trade).

Depreciation affects different home interests differently. A number of producers, at least until costs begin to creep up on them, will experience windfall gains in the event of devaluation. Firms that produce for export will find that they can for a while obtain higher prices in local currency without having to meet higher costs. Firms that compete with imports for the home market will discover that this rivalry has become less severe. And, to a lesser extent, every firm that produces goods that are in rival supply with exports or imports, will discover that they can now either sell more or charge higher prices.

The situation is more mixed in the case of labor. There may be more employment, particularly in those trades that export or

are in competition with imports, but real wages per day may fall. If the end result of devaluation is more exports and fewer imports, it is likely that the aggregate production of the nation must increase, and this normally should occasion more employment. However, depreciation normally means higher prices, and this will tend to raise the cost of living, especially if a large proportion of family budget goods has to be imported. Hence, unless money wage rates per day eventually rise too, in which case further depreciation may in time become necessary, real hourly wages must tend to fall. What happens to real annual *earnings* depends upon whether the employment effect outweighs the real wage effect.

In order to obtain an answer, one must distinguish between people who tend to have jobs at all times and those fringe workers, such as housewives, who are often on the brink of employment. Regularly employed workers may now obtain lower real annual earnings. Fringe workers may now obtain more annual earnings but enjoy less leisure. In most nations two-thirds or so of the national income accrues to the labor force. Hence, if depreciation reduces the economic status of a nation as a whole, it is hard to imagine how any productive factor that receives so high a fraction of total national income as does labor can fail to suffer.

In the final analysis, depreciation acts as a spur to producers and as a check rein on consumers. Consumers are in effect rationed. The quantity of imports that they can afford to buy will be less. They will also not be able to afford so many home-produced goods that can be sold abroad. Firms will relocate their sales so as to sell more abroad and less at home. Producers in the export trades, and in those trades that compete with imports, will turn out more goods. Depreciation puts the price mechanism to work.

The nation that finds its fortunes waning, and its exchange reserves failing, must at some time devalue. A long deferment of devaluation will only postpone the day when prices can start to guide producers and consumers. Conversely, in the case of a prospering nation which continues to amass gold and exchange, failure to *appreciate* prolongs the period of excessive exports, de-

ficient imports, and of providing others with unrequited material benefits.

### ADJUSTING TRANSFERS OF A COMMON MONEY

At one time, when gold was an international money and governments did not have active monetary policies, international adjustments to structural changes often occurred through transfers of a common money from those countries with "unfavorable" trade balances to those having "favorable" trade balances. The influx of money tended, in the absence of government intervention, to raise prices and incomes in the latter countries. Hence, their imports grew and their exports shrank.

#### A SIMPLE "COMMON MONEY" EXAMPLE

As an introduction to the subject let us imagine Canada and the United States using a single dollar currency, which can be freely transferred across the frontier, and that the two governments balance their budgets and leave credit creation and contraction to the private banking systems of the two countries. Further, let us suppose that there are no capital movements and that the net trade balance is zero. Suddenly this equilibrium is upset by important uranium discoveries in Canada. As a result Canada develops a net export balance with the United States. What adjustments may we expect?

We must consider all the uses, other than savings for the moment, to which the money that is now flowing north to Canada may be put. Some of it will be spent in purchasing more Canadian goods; for example, Canadians may consume more home-produced food and also invest in more home-produced factories. In addition, having more money to spend, Canadians can now afford to import more goods from the United States; some of these will be consumer goods (automobiles, for example) and some will be producer goods (farm tractors, perhaps).

Specific figures may make this more precise. Previously, exports



and imports were possibly \$1.0 billion a year each, and the aggregate income of all Canadians was perhaps \$25 billion. The value of the new uranium exports may amount to an additional \$0.1 billion a year. The outcome will then depend upon the tendency of Canada to import more producer and consumer goods as its aggregate income increases.

Let us suppose this marginal tendency to import is 0.2; that is to say, for every \$1.00 of *extra* income, Canadians will tend to import additional goods having 20¢ extra value. We know that the new equilibrium will be such that aggregate imports will again equal aggregate exports in value. Aggregate Canadian exports are now \$1.1 billion whereas formerly they were \$1.0 billion. The real question then is the extent to which income in Canada must rise before additional imports, amounting to \$0.1 billion in value, will be induced. The assumed tendency to import is such that there will be \$.2 million in extra induced imports for every \$1 million increase in Canadian income. Hence, national income must rise to \$25.5 billion (an increase of \$0.5 billion); then imports will rise to \$1.1 billion from \$1.0 billion, and equilibrium will be restored.

Naturally, if the Canadian tendency to import had been very high, say .5, then incomes in Canada would only have risen to \$25.2 billion.

Neglecting uranium temporarily, why should Canadians tend to export fewer old-style exports and import goods of greater value after their national income has risen? Part of the answer is that most demand schedules in Canada will shift upwards and to the right when buyers' incomes increase; after all, reservation prices of buyers depend upon both want and income. The rest of the answer is that supply schedules in Canada will tend to rise and shift to the left as the country's aggregate income increases, if only because competition raises the wages of workers, some of whom become uranium miners. When these two shifts occur less will be exported and more will be imported by Canada.

The process of adjustment through income change operates in both countries. When there is a net transfer of funds between

nations such as these, an income inflation in one (e.g., Canada) will probably be associated with an income deflation in the other (e.g., the United States). The circular flow of payments in the United States presumably decreases. Hence there is an induced reduction in United States purchases from Canada and a tendency to release more United States produced goods as exports. In the end equilibrium will be restored when all the induced shifts in the trade balance between the two countries offset the autonomous shift that occurred when the uranium mines were developed.

Another important consideration, so far ignored, is that the inhabitants of a nation that is gaining money are likely to lend foreigners more while borrowing less. Rising incomes, unless they are paced by comparable increases in the cost of living, will normally not be matched by equal increases in consumer spending, the balance representing increased saving. Some of this extra saving will become domestic investment. But some of it may be lent abroad, thus offsetting some of the "favorable" trade balance.

#### GOLD STANDARD SYSTEMS

There have been times, particularly among the western European countries of the sixteenth century, when the leading mercantile countries were on a *gold specie system*. They then used gold coins or specie as the mainstay of their domestic money systems. International transfers presented merely a physical and metallurgical problem. A merchant who wished to transfer funds between two gold specie countries had only to carry gold coins out of one country and present them at the official mint of the other nation. Here they would be melted down into bullion and refashioned in the likeness of another regal profile. In essence, apart from peculiarities of national minting, each country using gold coinage participated in a closed international currency system. Hence, a country with an export trade balance soon found its prices rising and its imports increasing. This gold specie-flow adjustment was in most respects the same as that which operates between two regions within a single country.

From 1875 to 1914 many of the Atlantic nations were on what has sometimes been termed an *automatic gold standard*. The money system of each nation consisted of bank notes, treasury coinage, and gold. In general, a holder of bank notes or deposits could redeem them ultimately in coins or bullion. Thus, legally at least, all money was ultimately redeemable in gold, although of course there would never have been sufficient gold to satisfy a general and universal demand for redemption.

However, a nation could possess a currency redeemable in gold, and yet not be on an *automatic gold standard*. The word "automatic" in this case entailed several points. First, it meant that the national government would not alter the gold content of its money—alter the currency price at which it bought and sold gold—in order to steal a march upon another nation or escape some temporary embarrassment. Second, it meant that there would be no official attempts, in the event that trade and investment credits and debits did not offset, to restrict gold movements. Third, and more positively, it meant that the government of a nation that was gaining gold would promote an expansion of demand deposits and bank notes, and conversely. A government that observed these three principles was said to be playing the "Gold Standard game."

The automatic gold standard of the past usually coped with autonomous disturbances, such as continuously and inevitably occur every year throughout the world, without requiring any specific government intervention. If Nation A's balance of payments unexpectedly became favorable, and remained so for several years, a number of long-run induced adjustments would be expected to occur. There would be an induced increase in imports, not only because the inhabitants of A now would have more money to spend, but also because prices in A would now be relatively higher. There would be an induced decrease in exports, not only because residents of other countries would now have less money to spend, but also because their local prices would now stand lower relative to those in A. Firms and persons in Nation A would now either borrow less or lend more on an international scale, because of their augmented incomes. All these induced changes would have the effect of either

increasing A's international debits or decreasing its credits. The adjustment mechanism in each case would be induced by differential changes in national income associated with imbalances in international payments.

#### **GOLD "STERILIZATION"**

However, following World War I, few governments issued currencies redeemable in gold or chose to follow the gold standard rules. The main violation was that central banks did not facilitate, or in some cases did not permit, sympathetic changes in the domestic stock of money as the national gold reserves waxed or waned. When a central bank received gold inflows, but did not use this extra gold to expand domestic means of payment, it was said that this gold had been "sterilized."

It is not difficult to imagine why gold sterilization—and the converse case of gold losses without money contraction—became a characteristic of gold standard countries between World Wars I and II. Much of the gold that the United States received during the latter part of this period was fugitive capital known as "hot money." It represented a panic transfer of funds to the United States that, had it not been for World War II, might one day have as suddenly reversed itself. The monetary authorities of the United States apparently preferred not to expand and contract the national means of payments in indirect response to totalitarian persecution, instability of central banks abroad, or vagaries of foreign diplomacy. Too many of the gold transfers of the period depended upon political and diplomatic incidents and too few on such economic fundamentals as the relation of national price levels. The gold standard of the inter-war period operated within a context of international instability beyond the experience of those who lived during the relatively placid times of the late nineteenth century.

In any event, whether or not gold sterilization policies were wise or necessary, their widespread adoption weakened the income adjustment mechanism previously described. The result was that gold movements did not necessarily alter personal incomes, inter-

national price relations, or the value of imports and exports. Gold movements remained partially dependent upon national income and price levels, but national income and price levels became wholly independent of gold movements. The circle of adjustment was broken and it has never been restored.

### GOVERNMENT MONETARY POLICIES

Governments *could*—though they seldom do—vary their monetary policies so that maladjustments between national and world economies are lessened. Thus, if a country had an unfavorable trade balance that was not offset by long term borrowing from abroad, the government of that country might attempt a gradual deflation. This it could do by raising taxes, cutting expenditures, and developing a budget surplus. Moreover, most governments have sufficient authority over the national central bank that, through the banking system, they can undertake a credit “squeeze” by raising reserve levels, selling securities on the open market, and so on.

The outcome would not be unlike that experienced in the earlier days of the gold standard. Of course, this adjustment would be deliberate rather than automatic. But there is little doubt that, if a government so desired, it *could* do much to keep the home economy in step with those of other countries.

Actually, most governments determine their monetary policies, as regards credit inflation and deflation, not with an eye to the international exchanges but rather with a view to maintaining full employment. Recourse instead may then be had to exchange controls, price ceilings, and even rationing. Some of the implications of these policies are considered in the next chapter.

### INTEREST RATE ADJUSTMENTS

Another potential mechanism of international economic adjustment that deserves special mention is that of interest rates. For many decades before World War II, central banks attempted to maintain some equilibrium in the balance of payments by adjust-

ing their interest rates, and this in turn tended to adjust all interest rates at home. The effects of such a change in a *laissez faire* world are not without interest even today. (For example, in 1956 and 1957, the Conservative government of Great Britain resorted to this traditional instrument of control.)

If a central bank found that the national balance of payments was becoming adverse—as for example when an unfavorable trade balance was not compensated by lending from abroad—it would announce a higher rate at which it would rediscount various kinds of commercial paper. This would raise interest rates on all short-term capital in the financial centers of the country. This in turn had a two-fold consequence. A certain amount of domestic borrowing would be deterred by the higher interest rates, and in the long run this often proved most important. Also, and of more immediate significance, short-term capital would be attracted from foreign financial centers by the prospect of higher interest earnings. The effect of these transfers of short-term capital was to augment the gold and foreign exchange reserves of the central bank and so offset the drains upon them resulting from the unfavorable trade balance.

This method, of short-term adjustment to ebbs and flows in balance of payments historically preceded the government exchange controls and exchange stabilizations funds that are so commonplace today. In nearly all cases the advent of these last has greatly diminished reliance upon “bank rate” and induced short-term capital transfers as a temporary means of stabilizing the exchanges. However, it is worth remembering that interest rate adjustments have proved to be an important means of restoring equilibrium in the past and it is not inconceivable that the government exchange controls of today will sometimes give place to an era of greater economic freedom.

## NATIONAL INCOME AND INTERNATIONAL ADJUSTMENTS

Before concluding, something should be said about the interactions between exchange rate variation and international money

flows that are related to one another through changes in national income. This subject is treated more exhaustively for economists in Appendix A. The following is a very simplified and abbreviated paraphrase of the same ideas.

Modern economic theory often supposes that national (money) income is a function of certain monetary "leakages" (that tend to reduce national income) and certain "injections" (that tend to increase it). The two main "leakages" of money, which are themselves related to the level of national income, are merchandise imports and domestic saving. Thus, if it is said that a country's marginal propensity to import is 0.2, this means that, given an increment in national income of say, \$1,000,000, imports will increase by \$200,000. Other things equal, a reduction in this marginal propensity to import will result in a higher national money income. The two main "injections" of money are merchandise exports and domestic investments. If foreigners begin to spend more of any given national income of theirs on our exports—i.e., *their* marginal propensities to import increase—*our* national income is likely to increase. Similarly, if public and private investors at home decide to increase their disbursements, national income is likely to rise.

In a "closed" economy—one in which there is no economic intercourse with the outside world—the equilibrium national income will be such that the amount that domestic residents *intend* to save from their incomes is equal to the amount that they *intend* to invest from these same incomes. Aggregate actual saving must equal aggregate actual investment, and so the only possible equilibrium national income is when the intentions of savers and investors are equal in money terms. (Analogously, the equilibrium price for carrots in a vegetable market is that which equates demand and supply, which means that intended purchases at this price are equal to intended sales at this price.)

However, economies are not "closed," and so in reality there is an import leakage as well as a domestic saving leakage, and there is an export injection as well as a domestic investments injection. In dollar terms, the sum of domestic saving plus imports must

equal the sum of domestic investment plus exports.<sup>1</sup> Hence the equilibrium national income must be such that the amount that people—including the government—want to “leak” at this income is equal to what they want to “inject” at this same income. (See the first figure in Appendix A.)

Anything that increases the amount that people will want to “leak”—i.e., import or save—at each given level of national money income will tend to reduce the equilibrium national income. For example, reductions in import duties and quotas will increase the marginal propensity to import. On the other hand, a decision by the government to cut taxes but not expenditures, irrespective of income, will have the effect of increasing the “investment injection,” and hence lead to larger money incomes.

Now we must introduce the exchange rate into the argument. Theoretically, for each exchange rate, there is, given the various propensities to “leak” and “inject,” some one equilibrium national income. Depreciation, assuming demands and supplies of goods in international trade are elastic on an average, will result in fewer payments for imports (thus reducing a “leakage”) and more receipts for exports (thus augmenting an “injection”). Hence a lower foreign valuation of the national currency is likely to result in a higher equilibrium income at home.

However, it must always be remembered that national income is measured in money. An increase in national money income will not add to human satisfaction if product and service prices are rising at a faster rate than income. And, as we have seen in this chapter, depreciation tends to worsen the commodity terms of trade, requiring the nation to export more physically and/or import less physically.

The ideal, which may require more skill and luck than most governments seem to possess, is to do those things that increase money incomes but only raise prices very modestly or not at all. Some of these things may be exchange depreciation and deficit

<sup>1</sup> Expressed differently, the excess of exports over imports must equal the excess of domestic saving over domestic investment; the difference in each case represents domestic lending abroad.



budgets. Of course, the internal incidence of such policies is uneven for different classes, especially if a resultant price inflation steals from all those whose incomes or wealth are defined and fixed in money terms, examples being insurance policy holders, retired persons on pensions, and widows with trusts invested in bonds. In matters of economic policy there are never any universal panaceas and always some social inequities.

### PROBLEMS

1. "Every Briton knows that our coal mines are nearing exhaustion and our mining costs are increasing. We're even importing coal for the first time in our history. The government should impose a price ceiling on coal in Britain so as to plug this drain on our foreign exchange reserves." *Evaluate.*

2. "In the days of an automatic gold standard all the leading nations were in effect using a common money, and international adjustments to structural changes could occur automatically." *Explain.*

3. "We are suffering from inflation in this country and are already buying £100 million a year more from abroad than we are exporting: if we want to stop rising prices and costs we had better check these imports through additional restrictions." *Evaluate.*

4. "Depreciation will always increase the value of our exports—measured in local currency—and so it can be counted on to eliminate an 'unfavorable' trade balance." *Evaluate.*

5. "The world supply of an import to a country that provides only a small part of the world demand for an internationally traded commodity is likely to be quite elastic." *Explain.*

6. "If too many of the world's demands and supplies are inelastic we might as well forget about fluctuating exchange rates as a means of maintaining international equilibrium." *Explain.*

7. "Higher interest rates mean higher costs, higher prices, and higher imports in turn; hence raising the central bank's discount rate can only make our trade balance more unfavorable." *Evaluate.*

8. "Everyone in this country, assuming this will restore the trade balance, should thank the government for having the courage to depreciate our currency." *Evaluate.*

9. "A deliberate policy of credit 'squeeze' has much the same effect

as a loss of gold under an international gold standard—assuming governments follow gold standard ‘rules of the game.’ ” *Explain.*

10. “If deficits are due to inflation at home, we will not achieve a corrective tendency through devaluation alone.” *Explain.*

## CHAPTER 6

# Controlled Disequilibrium

In the preceding chapters the role of government has been neglected for the most part. In the discussion of how national economies react to one another through reinforcing income and exchange rate changes, it was not pointed out that many of these automatic adjustments depend upon transactions that are now illegal. The international accounts of most nations today record a state of controlled disequilibrium.

Under these circumstances one might well ask why economists still concern themselves with analyses of international equilibrium under conditions of *laissez-faire*.

The answer is not simply failure to keep abreast of the times. A state of affairs in which people can buy and invest as they prefer is still the most natural, even though it may no longer be normal; the fact that Lake Meade is normally filled with water banked up behind Hoover Dam is not inconsistent with the principle that water runs downhill. Moreover, a study of automatic international adjustments serves to establish a standard against which situations of controlled disequilibrium can be compared.

### GOALS AND MOTIVES OF GOVERNMENTS

If anything is certain, it is that the elected and appointed officials of governments have little interest in the abstract *laissez-faire* equilibria of economists. After all, unless conditions of controlled disequilibrium were believed superior to those of free equilibrium,

there would be no *raison d'être* either for government intervention in economic affairs or for the administering officials. And under certain circumstances, such as during and after wars, beneficial government intervention is possible but not inevitable.

The simple truth is that many national governments are primarily concerned with improving the economic welfare of those domestic voters that support them politically. The economic welfare of other fellow nationals is often a secondary consideration. Moreover, most national governments tend to be quite uninterested in the economic well-being of foreigners.

There are many ways in which a government, through the control of international trade and investment, can temporarily advance the interests of some domestic voters at the expense of others. It is surprising how frequently, on closer examination, regulations that superficially appear to involve a gain for one nation and a loss for another are rather seen to involve an internal conflict of interest. Specific import restrictions benefit some domestic producers but injure some other domestic producers as well as domestic consumers. Currency depreciation tends to work to the advantage of employers at the expense of employees. And a government policy of buying domestic farm produce at high prices and subsequently dumping it abroad at low prices benefits rural areas while injuring urban populations and the long-suffering taxpayer.

Different governments naturally do not have the same economic goals. Immediately after World War II, the governments of war-ravaged countries tended to emphasize industrial reconstruction and agricultural rehabilitation. Nearly all the governments of industrial nations are now committed to securing and maintaining full employment. Governments that depend upon the support of organized labor seek to raise wages and to hasten the extension of social security benefits. A few governments make it a cardinal policy to keep food prices down in order to benefit urban voters. And in a few small and undeveloped countries, still feudal in spirit, the local government may seek, through appropriate policies, to increase the profits of those families owning important mineral reserves being worked for export.

Whatever their motives, governments tend to seek their ends through the employment of one or more types of controls. Fiscal policy may be directed toward increasing domestic means of payment, and at the same time price ceilings may be used to nullify one of the new policy's effects. Imports may be restricted through tariffs, quotas, a hostile bureaucracy, or an exchange control that will not permit the acquisition of foreign exchange to purchase certain imports from particular countries. Exports may be limited through licensing schemes or stimulated through subsidies. Allocation of scarce and necessary materials may favor exporting industries. The transfer of capital funds abroad will probably be regulated. Inter-governmental loans may serve to determine the character and routing of goods entering international trade. State trading monopolies may be established in the export and import of various commodities such as rubber, wool, and tea. And when a particular industry has been nationalized, the state normally determines not only its foreign trade output but also the capital equipment that may be imported for it. Between the Soviet Union and its satellites at one extreme and the United States at the other, there are numerous mixed economies, part completely free and part severely controlled.

### **FULL EMPLOYMENT PROGRAMS**

It is reasonable to suppose that the governments of most industrialized nations will in the future attempt to prevent widespread unemployment by using inflationary fiscal policies. With the onset of abnormal unemployment they will probably ease credit, undertake public works, subsidize various sectors of the economy, cut tax rates, and meet their resultant budget deficits by borrowing from the central bank. In this way, unless the spending time lag of firms and households increases incommensurately, effective demand will presumably be increased.

One consequence of an inflationary fiscal policy, in the absence of legal restraints, is an increase in the volume of imports. This will occur even when there is no tendency for domestic prices to rise. The mere fact that people have more money to spend will cause

them to buy more of everything, including extra imports, and also more of the goods that were previously sold as exports. Foreign owners of domestic companies may now receive more profits—partly as dividends—and more nationals will travel abroad as tourists.

These effects will be reinforced as prices of goods and costs of production will begin to rise at home. Sooner or later, if attempts further to increase effective demand are continued, the additional employment of formerly idle resources will become less and less. The economy will lose its slack of idle resources, and higher prices rather than greater employment will become the consequence of further budget deficits. Higher domestic prices will affect the trade position in a still more unfavorable manner.

The reaction of government to these developments can be expected to take the form of import restrictions, domestic price controls with rationing, or possibly currency depreciation.

#### **IMPORT RESTRICTIONS**

In one way or another a government bent on full employment through fiscal inflation will strive to thwart the propensity to import as domestic incomes rise. The most effective and usual means in such an emergency—the particular incidence of which will be investigated in Part IV—are quotas designed to limit the maximum quantity of each import, and exchange control administered in such a way as to limit aggregate expenditure on imports. The immediate objectives of such a policy to restrict imports may be two-fold: (1) to prevent an increased leakage through imports, and so increase the probable increase in money incomes; and (2) to prevent any necessity for depreciation, and so postpone a worsening of the barter terms of trade.

What will happen to the value of a country's exports if a maximum limit is set on the aggregate value of imports?

If exports previously exceeded imports in value, and were previously financed by capital loans to foreigners, it is important to determine whether the previous value of exports was limited by the

*desire* or by the *ability* of foreigners to buy the country's exports. If foreigners were formerly purchasing all the exports they desired, any tendency of domestic residents to lend abroad as their incomes rise will also tend to depreciate the national currency. In this case exchange control might well be used to limit capital transfers. On the other hand, the previous situation may have been one of disequilibrium, in the sense that foreigners would have bought exports of greater value save for their inability to acquire the country's money. Then any tendency to lend more abroad may also tend to increase exports by almost a like amount. For as long as this is true, neither imports nor lending will constitute serious leakages, and limiting import debits will not bolster national income.

If imports previously exceeded exports in value, the nation must have been either borrowing from abroad or drawing down foreign investments and balances. It is hard to predict whether the new inflationary fiscal policies and accompanying controls will deter foreign lenders from whom funds had previously been borrowed. On the other hand, if the import balance had formerly been financed through liquidating foreign assets, a drastic curtailment of imports might defer the date when these foreign assets become exhausted.

In general, except when value of exports is limited only by the inability of foreign buyers to acquire the national money, imports tend to be a leakage. If a government is seeking to inject newly created bank credit into the circuit of payments, it is not likely to look upon increasing import leakages with favor. If a nation's firms and households exhibit a marked propensity to import more as incomes rise, the local government will almost assuredly prevent any considerable increase in the aggregate value of imports by imposing quotas and exchange controls. (See Appendix A for an explanation in detail.)

#### PRICE CEILINGS AND COMMODITY RATIONING

As already mentioned, rising incomes will cause higher domestic prices, higher labor costs, and a host of troubles. For one

thing, increased local consumption of exportable goods will probably result, and import quotas and exchange control are powerless to prevent local producers from selling less of their output abroad in order to sell more domestically at more attractive prices. For another, the local market demand for importable goods will come to exceed the supply of imports and home production. Many governments, confronted with such a situation, are inclined further to limit entrepreneurial and consumer discretion.

Domestic producers of exportable goods are normally at liberty to allocate their output between the home market and the export trade at will. If domestic prices are rising because local buyers now enjoy higher money incomes, and if the net price equivalent in local currency of exports remains unchanged, fewer goods will be exported voluntarily. This tendency will be augmented by a tendency for local money costs of production to rise and so curtail supply. Under these circumstances the domestic government may establish an allocation scheme (if the good is a producer good) or a rationing program (if the good is a consumer good). Of course, a strong domestic demand and a legally restricted domestic supply will tend to force prices up very markedly in the absence of restraints; this will probably be unpopular with the public, and the government may not allow the affected entrepreneurs to gain wind-fall profits. Consequently, the rationing scheme will probably be supplemented by price ceilings. In this way the government will seek to force more output into the export trades where it can earn or save foreign exchange.

Import scarcities will occur because the government's import restrictions will prevent a normal adjustment to the increased effective demand at home. Prices of importable goods will consequently tend to rise in the domestic market. If these goods bulk large in the budgets of most families, the government may fear the political repercussions of rising domestic prices: as a result, it may seek to freeze prices at their former levels through price-ceiling regulations. Home production, already faced with rising money costs of production, will immediately be curtailed. The resultant market shortage will be further aggravated, and in all probability the home



government will be forced to impose allocation or ration controls. It may even subsidize the home production of such "cost of living" items as food. This may further unbalance the budget and hasten inflation.

The import situation may under certain circumstances tempt the domestic government into state trading. If the government is willing to permit local prices to rise, but is unwilling to permit private importers to gain windfall profits, it may prohibit all private importation of certain goods. It will then purchase goods on the world market as a monopsonistic importer, and sell them domestically at a profit in local currency. If the imported goods are deemed to be luxuries rather than necessities, the government may resort not to commodity rationing and price ceilings but to soaking the rich instead. In practice, however, the total value of luxury imports is not very great.

Most governments, particularly if foreign trade represents a substantial part of the nation's commerce, will be unwilling to permit any marked rise in the domestic prices of importable and exportable goods. Hence, price controls and commodity rationing, and some subsidization, are more than probable. The economy will then drift into a state of suppressed inflation.

#### **CURRENCY DEPRECIATION UNPOPULAR**

One might rather naively inquire why a government that seeks full employment through fiscal expansion should prefer suppressed inflation to outright currency depreciation. Instead of numerous controls to force exportables into foreign trade, why not simply permit the national currency to depreciate in the foreign exchange markets? Instead of import quotas and ration schemes, why not allow currency depreciation to raise domestic prices and so curtail market demand at home?

In many instances the over-all effects of import quotas and domestic rationing are much the same as those of currency depreciation. However, their specific incidence on individual families and social classes can be very different. If a government prefers the

complexities of specific controls to a single act of currency depreciation, the answer must usually be sought in special-interest politics.

Currency depreciation in effect rations the domestic use of importables and exportables because it raises their local prices. But the incidence of rationing by the purse is dissimilar to rationing by legal enactment. Some goods, such as bread, are bought by families of widely different income and represent very different fractions of these families' budgets; a doubling of bread prices would hence reduce the physical consumption of poorer families comparatively more than that of well-to-do families. There are also imports, such as champagne, that tend to be purchased only by the rich and others, such as margarine, that tend to be consumed only by poor families. Currency depreciation will deny both imported necessities to the poor and imported luxuries to the rich.

Depreciation, because it raises the local prices of all importables and exportables, tends to favor employers at the expense of employees. Although wage rates may eventually be forced up as a consequence of higher living costs, they will normally lag behind product prices, and this will temporarily reduce the real wages of workers while increasing the unit profit margins of producers. Moreover, if depreciation is to remedy the nation's balance of payments difficulties, the government of the day must seek to perpetuate this lag; higher wage rates might simply compel another currency depreciation. Actually, however, a government that stresses full employment is likely to be kept in office by a labor vote, and no such government will prefer currency depreciation (which cuts real wages) to price controls and rationing (which discriminate against the well-to-do).

There are also less tangible reasons why governments are often loathe to depreciate. The international valuation of a nation's money is often a source of patriotic pride and national prestige. Voters may feel that a government that is forced to depreciate its currency has mismanaged the economic affairs of the nation. Businessmen may find it more difficult to attract capital from abroad at a time when the currency is under selling pressure. The middle classes may come to fear for the purchasing power of their lifelong

savings. Full-employment policies may lose much of their electoral popularity when the public comes to realize that credit inflation may also occasion hidden wage cuts and lost savings. Most governments strive to preserve the illusion that their fiscal prudence is available at little or no real cost.

### DISCRIMINATION AMONG IMPORTS

Most nations—unlike the United States—are very greatly dependent upon imports to sustain their populations and operate their basic industries. Therefore, the volume and character of imports are of concern to most countries and governments. Policies must be considered that will not only earn a desirable sum of foreign exchange but also ensure its wise expenditure on imports.

By way of example let us consider some of the typical problems confronting the liberated countries of western Europe following World War II. These countries, through depreciation of plants, war damage, shifts in population, and loss of foreign investment income, had lost much of their capacity to produce or import peacetime goods. Their agriculture was so impoverished that they were more dependent than ever upon food imports. Their factories could only be re-equipped without delay by purchasing capital goods from abroad. And at this very juncture the export industries were unable to produce enough to earn foreign exchange even in prewar amounts. Under such circumstances each affected government had to consider ways to increase export earnings—especially from North and South America—and to ensure that foreign exchange was used to purchase certain imports rather than others.

Recourse was had to a number of different selective controls in an attempt to increase foreign exchange earnings. Most exports were put under license. If the foreign demand for an export seemed rather elastic, export licenses would be granted without question, particularly if the sale was to a hard currency buyer and the export in question was not deemed necessary for domestic rehabilitation. However, export licenses were sometimes refused if the good was

considered a domestic necessity, if the buyer intended to pay in a soft currency, or if the foreign demand appeared obviously inelastic. In these ways the licensing machinery was used to discriminate between the export of luxuries and necessities, between hard and soft money buyers, and between elastic and inelastic foreign demands.

Governments also took more positive steps to promote exports. One of these was to establish internal allocation programs for such essential materials as steel, fuel, and industrial chemicals. The subsequent allotment of steel to an automobile manufacturer might then depend upon whether he produced trucks for domestic use (thereby saving the use of dollars to import them) or limousines for wealthy residents (a relative luxury). Fuel might be allotted to firms making chinaware for export but not to laundries doing work that housewives could perform. In a rough-and-ready way these allocation schemes shifted production away from local luxuries to necessities and from local consumption into export sales.

In regulating imports, each government, through a system of import quotas and by means of exchange controls, sought to arbitrate among competing domestic buyers. Smokers wanted the importation of tobacco. Low-income households wanted cereal imports and the better-off wanted meat imports. The prosperous wanted automobiles and gasoline. Manufacturers wanted imported raw materials and heavy equipment. Farmers wanted commercial fertilizers, livestock feed, and farm machinery. Thus the importation of cotton and the spending of soft currencies to buy it might have been permitted, but not the use of dollars to import automobiles from America. Government officials had to strive to balance the needs of the poor against the desires of the wealthy and the exigencies of the present against those of the future.

These very complete controls—embracing not only exchange controls but also import and export licensing and internal allocations—were in part an emergency program of the reconstruction period. By 1951, especially on the European continent, the schemes of internal allocation had been relaxed, together with a number of

other controls. Nevertheless it is still evident, half a decade later, that many governments will never again permit the comparatively untrammelled international commerce of the 'thirties.

There are probably several reasons for this reluctance on the part of governments to liberate international trade and finance. Some of the less creditable ones should in all honesty be briefly stated. A government cannot so effectively favor one special-interest group over another, and so solicit the votes or money of the more influential group, unless it has rather stringent economic controls to administer. Moreover, the administration of economic controls has become a way of life as well as a means of livelihood for a generation of officials.

In the present state of the world a very plausible case can be made that the welfare of some nations depends upon control of international commerce and capital. World War II left a backlog of indebtedness that even today in many cases would occasion large exchange rate variations if capital transfers were suddenly freed. And on current account it must be recognized that controls breed controls, both within a single nation and among countries. Governments that are willing to impose stringent controls are able to enter into bilateral compacts with other governments, that may benefit each at the expense of other nations. A government that insists on *laissez-faire* will have less bargaining power vis-à-vis other governments. It is rather irrelevant to argue that each nation might be better off economically if all would forswear the control paraphernalia of the modern state. The significant fact is that, so long as most *other* nations practice the arts of licensing, exchange control, and bilateralism, the fruits of isolated economic liberalism are likely to taste sour.

### SOME CONSEQUENCES FOR ECONOMIC THEORY

It is evident that as long as governments enforce licensing systems and exchange controls, variations in exchange rates or national income levels will be inadequate to maintain or restore international equilibrium. The normal consequences of these variations will be

checked by more specific regulations. A nation's imports or exports will not depend upon demand and supply conditions at home and abroad but upon some government policy as implemented by exchange-control and trade-licensing officials. Accordingly, a sceptic might be justified in asking whether anything remained in the study of international economics, and whether economic analysis has not been replaced by pressure politics.

It is quite true, of course, that as long as drastic economic controls continue, economic analysis will have less prediction value. For example, it is no longer possible to anticipate that domestic inflation will inevitably lead to currency depreciation, or that an increase in foreign demand for some exportable good will inevitably decrease its domestic use. These consequences can only be expected if existing governments do not prevent them from happening.

Nevertheless there are still many important economic forces at work beyond the authority of any single national government. The relative significance of imports to *another* country is still something that no domestic government can very well alter. The circumstances that give one nation a comparative disadvantage in the production of some good (its climate, mineral reserves, topography, geographic position, and relative supplies of factors, for example) are facts of economic life that no government can alter. A government can determine whether or not a good *shall* be imported but it cannot regulate whether or not it *should* be imported. This sort of question must be decided with the help of economic analysis and will depend upon physical facts.

The validity of the opportunity cost concept is not dependent upon the political complexion of a nation's government or upon whether its economy is organized along socialistic or capitalistic lines. Suppose a country normally imports X costing Y dollars. Its government might contemplate three alternatives: (1) Should Y dollars perhaps be spent on other imports instead, in which case analysis will be needed to ascertain what other imports Y dollars can buy? (2) Should X be produced at home instead of something else, in which case analysis will be needed to ascertain the relative use values of these displaced outputs? (3) Should goods capable

of earning  $Y$  dollars of foreign exchange have been exported (rather than consumed at home)? In this instance analysis will be required to estimate the relative domestic use value of the actual exports and their conceivable substitutes. Economic analysis will be required so long as goods are scarce and there are alternative ways of satisfying human wants.

One major distinction between controlled and free enterprise economies is that income inequalities are viewed as social inequities in the former and as a rough measure of economic contribution in the latter. If income inequalities are considered a necessary incentive to work and produce, there is little gained and perhaps something lost from government intervention, because the price system may well value all opportunity costs more accurately than any administrative official. An apparent need for specific controls usually arises when the government or the public becomes convinced that existing income inequalities are unjustifiable; then, unless there is redistribution through taxes and subsidies, income differences may deliberately be circumvented in their effects.

The Labor government that was first elected in Great Britain in 1945, to give one outstanding example, sought to nullify the price system in many important respects. If luxuries were produced in Great Britain they had to be mainly for export. The foreign exchange that these exports earned was then spent to import the goods demanded mainly by the working class. Hence, in Great Britain, one could freely buy beer or ale but champagne or Scotch whiskey were rationed or unavailable. Even a class-conscious government could not ignore certain economic forces with impunity, however. In acquiring foreign exchange it had to observe economic principles; thus, luxuries were produced in considerable quantity in Great Britain for export because the United Kingdom thereby exploited its comparative advantage in making them.

Economic efficiency—but perhaps not political survival—has two facets: the proper rate at which a nation's productive resources should be employed, and their proper allocation among different uses. The man in the street understands the meaning of unemployment, but not even all economists understand the meaning of

proper resource allocation. It may be just as important, however, that resources be used to produce the right goods in the right places than that the right balance between leisure and employment be attained. A national government that is bent upon full employment through fiscal expansion, and shuts off all extra imports in order to plug this leakage, may gain employment efficiency while losing allocation efficiency. The final result may be not only that more people are working, but also that the economy is struggling against nature to produce the very goods it should be importing in order to exchange them for goods it should be exporting. The significance of opportunity costs does not cease when obscured by popular emphasis on full employment.

There is another fundamental aspect of international economics that no government can alter and which may in the end destroy it. No government can force foreign buyers to purchase its country's exports; and it cannot force foreign investors to lend its businesses more foreign exchange. Consequently, if a nation is dependent upon imports, it will eventually become dependent upon foreign buyers and lenders. Its standard of living will become dependent upon the quality, attractiveness, and cheapness of its exports, and upon the investment opportunities afforded foreign lenders by its industries and government. Consumption must wait upon production and the relative demand of each nation for the goods of others. In the final analysis, the foreign export buyer may outweigh the domestic voter, competitive strength may outweigh social aspirations, and economic reality may outweigh political promises.

The widespread phenomenon of controlled disequilibrium reflects the exaggerated notions of many people and governments regarding the standard of living to which their compatriots can realistically aspire.

### PROBLEMS

1. "A study of economic equilibria is not without value even though governments may have other goals." *Explain.*
2. "We are told that credit inflation at home threatens the foreign



value of our currency because imports tend to rise. The solution then is to prohibit nearly all imports. We can then have full employment, maximum production, and the highest standard of living." *Evaluate.*

3. "So long as a nation is dependent on large-scale imports it is dependent on foreign importers and foreign lenders." *Explain.*

4. "Currency depreciation, by restricting physical imports, rations everyone within the country, rich and poor alike, and so is preferable to import quotas for specific commodities." *Evaluate.*

5. "The concept of opportunity costs is of little use to a socialist economy." *Evaluate.*

6. "Imports that result from rising domestic incomes may not upset the trade balance if foreigners were previously willing but lacked the funds to buy more of our exports." *Explain.*

7. "It is hard to see how a government can drastically inflate credit, raise money incomes, and maintain the foreign value of the national currency without fairly stringent foreign exchange controls." *Explain.*

8. "The payments difficulties that still prevail in many countries are largely the manifestation of inflationary pressures arising from overambitious plans for investment and excessive expectations for consumption." *Exemplify.*

9. "The only protection for the reserves of a country such as Britain is a strong payments position; it is not to be found in a little weak wall of controlled inconvertibility, which is a symbol of weakness and provides no defense whatever." *Explain.*

10. "In Brazil, there isn't a person in authority who doesn't see clearly now that they have cheated themselves in special 'controlled' government-to-government selling arrangements. They have sold their coffee for imports worth the equivalent of 20 cents a pound in some places when they could get 50 cents in the United States and Western Europe." *Discuss.*

11. "Countries that overvalue their currencies in terms of the dollar by using artificial controls merely perpetuate the problem they are really trying to solve." *Evaluate.*





**PART III**

**INTERNATIONAL  
PAYMENTS AND  
MONETARY PROBLEMS**



## CHAPTER 7

# The Balance of Payments Among Nations

All the international transactions of residents of, say, the United States can be summarized at the end of the year into a *balance of payments* of the United States with the rest of the world. This is a most important accounting record because it shows whether a country is paying its way internationally, whether it is lending or borrowing from other countries, and whether its currency is becoming “stronger” or “weaker.” To understand a nation’s balance of payments requires effort, but this is not difficult if certain definitions are learned.

### HOW CLAIMS AND COUNTER CLAIMS ARISE

The *balance of payments* is really a balance of claims and counter claims between, say, United States residents and residents of all other countries. If it had been properly named when first introduced, four centuries ago, a lot of confusion would have been avoided. Hence, we shall start by considering the principal ways in which claims and counter claims arise from international transactions. The most important and obvious ones arise from exports and imports of goods and services. But long-term investments also give rise to claims and counter claims. And when payments are received in settlement of outstanding claims, thereby reducing

them, these receipts in turn are treated as a sort of counter claim.

*Merchandise Trade.* If a firm or an individual in the United States sells merchandise to anyone in a foreign country, this American export gives rise to a "for-us" claim. This is variously called a credit, positive, or favorable transaction in the United States balance of payments. When someone in the United States imports merchandise from abroad this occasions a "for-them" claim or debit transaction. This holds true whether payment is made by the purchaser immediately, several months later, or in a following year. It is important to remember that it is residence and not citizenship that decides whether a claim is a debit or a credit in the balance of payments. Thus, if an American resident in France buys a car from Detroit, this transaction is still a United States export credit. The merchandise trade account is sometimes called the *balance of trade*, and this is said to be favorable when exports exceed imports in value, but the balance of trade sometimes includes "invisible" sales and purchases of services.

*Services.* Many different kinds of foreign services are purchased by persons in the United States in the course of a year, and these all occasion debits for the United States because they give foreign residents claims for payments. Examples are the purchase of hotel and restaurant service by American tourists, the use of foreign shipping to move American-owned goods, and brokerage and insurance services. On the other hand, when a foreign resident purchases a ticket on a United States airline, there is a service sale, occasioning a United States credit. The sale of services are often referred to as an "invisible" export because no goods are seen crossing a frontier.

*Interest and Dividends.* Americans have invested heavily in foreign branch plants, and in the securities of foreign governments and corporations, and these investments give rise to interest and dividends. These are "for-us" claims and constitute credits. The profits of foreign branches of United States corporations are often grouped with interest and dividend claims.

*Long-Term Investments.* When United States residents make relatively long-term loans to foreign residents by purchasing foreign stocks, bonds and other evidences of indebtedness, these purchases

occasion debits for the United States, because their immediate effect is to give the foreign borrower a claim for payment of the funds he has just been lent. Subsequently, perhaps many years later, repayment of the loan by the foreign borrower will fall due, and this right to repayment will constitute a United States credit for the year in which it occurs. All international forms of disloaning and disinvestment by Americans give rise to United States credits also.

*Short-Term Loans.* Some debts, such as Treasury bills, have very short maturities—30, 60, or 90 days. Purchase of debts which mature within less than twelve months constitutes short-term lending. If foreign residents increase their *holdings* of United States Treasury bills and commercial paper, they are in effect lending to our government, banks, or businessmen, and there has been a "movement"—really a net change in stocks—of short-term capital towards the United States. Such a movement will occasion credits for the United States because Americans have sold short-term debts to foreign residents on balance, and now have a claim for payment of the purchase price involved.

*Gifts, or Aid.* Gifts of merchandise often show up as exports, but do not entail a claim on foreigners. How are the relevant facts shown in the balance of payments? By the balance of payments statisticians show the value of the gifts as a counter gift debit.

If an Italian immigrates to the United States, for example, and wishes to send a money gift to his relatives in Italy, this will constitute a United States debit. The reason for this is that he will send an instrument, such as a postal money order, that will give his family in Italy a claim against the United States government, or against an American bank or private person.

*Gold Purchases and Sales.* If a foreign government or corporation sells gold to the United States Treasury, or to one of the Federal Reserve Banks, this sale gives the foreign resident a claim for payment, and is therefore a debit for the United States.

*Payment in Money.* We have seen that any transaction, such as exporting, that occasions an international claim for payment in



money is a credit for the claimant country. It follows that when a claim is discharged through an actual money payment, there is no credit remaining, and the act of wiping it out is a debit for the country that no longer has the credit. Thus, when United States residents receive payments of money from residents of the United Kingdom, there is a debit in the United States balance of payments, because former creditor claims have been dissolved. The distinction between the act and date of establishing a claim for payment and the act and date of discharging this claim, is very real; in international merchandise trade, for example, the contract to buy and sell may be concluded 90 days in advance of payment. Payment is deemed to have occurred when the American creditor receives bank balances or national currency from the foreign debtor. The thing to remember is that there is always a debit for the United States when the possession of foreign bank balances and currencies by Americans increases, or when foreign possession of United States bank balances and national currency decreases. Of course, if Americans add to their foreign balance while foreigners add to their American balances, there is no net payment and hence no net debit or credit. (The ways in which international payments are actually made are described in Chapter 8.)

The same transactions that are having their dollar values included in the United States balance of payments are of course being entered in the balance of payments of some foreign country—but valued in its currency. This is true irrespective of the currency in which the transaction was contracted. And if the transaction causes a debit in the United States balance it will cause a credit in the foreign nation's balance of payments.

A statistical problem is that exporting countries usually value exported merchandise *exclusive* of shipping charges, whereas the importing country is likely to include transportation costs in the value of the import.

Logically one could construct a United States balance of payments with France, another one between the United States and Italy, and so on. This would be revealing, but such individual country balances of payments are not so frequently published. Also,

a balance of payments can be prepared for any time period, and the Department of Commerce, for example, does publish quarterly estimates in addition to the more usual annual statements.

Students often try to identify a nation's balance of payments with some other more familiar accounting record such as a business balance sheet or income statement. But a balance sheet shows assets and liabilities at a moment in time, while an international balance of payments shows the accumulation of claims and counter claims over a period of time. A firm's income statement shows the value of sales and the costs of acquiring the sold good, whereas a country's balance of payments does not show whether it made a profit or loss on the things that it exported. There are other differences besides. The only real similarity is that, like other accounts that depend upon double entry, a nation's balance of payments must always balance, because an export, for example, must result in a payment or a debt. Otherwise it is best to forget orthodox accounting and remember instead that we are here dealing with nothing more than a totalling of the *claims and counter claims* for payment, categorized for convenience, that arise over a period of time between the residents of one country and those of others. The proof that we are concerned with claims rather than payments is that the receipt of money—currency or bank balances—is always a debit entry.

### THE INTERNATIONAL ACCOUNTS OF THE UNITED STATES

A study of the balance of payments of the United States in selected years can teach us something about the place of the United States in the world economy. It can also tell us something about the ways in which the hundreds of thousands of international transactions that affect the United States each year can be classified into account categories. The United States Department of Commerce regularly prepares a balance of payments for the United States and the International Monetary Fund publishes similar estimates for all the principal nations.

Tables 7.1 and 7.2 provide certain information about the United States balance of payments. Table 7.1 gives this information for

1938, 1947, and 1954. Table 7.2 provides a geographic breakdown for 1954, showing the United States balance of payments with the sterling area, Canada, and Latin America. The classification system, however, is not exactly the same in both tables.

TABLE 7.1  
UNITED STATES BALANCE OF PAYMENTS, 1938, 1947, AND 1954  
(millions of dollars)

	1938	1947	+	1954 —	Net
Merchandise*	+1,020	+9,447	13,615	13,392	+223
Services	-132	+979	1,967	2,187	-220
Investment Income	+431	+1,007	2,807	549	+2,268
Current Account	+1,319	+11,433	18,389	16,128	+2,271
Aid and Gifts	-174	-2,836	--	—	-2,028
Long-Term Loans	+90	-3,938	443	309	+134
Private Direct Invest.	-38	-916	205	1,402	-1,197
Short-Term Capital & Bank Deposits	+355	-439	1,235	643	+592
Gold	-1,799	-2,848	—	—	+310
Errors & Discrepancies	-249	+710	—	—	-82

\* Includes government and "not included elsewhere" on current account. Thus the 1954 merchandise balance includes a net debit of \$2,527 millions due to government purchases of foreign goods and services.

SOURCE: International Monetary Fund, *Balance of Payments Year Book*.

Table 7.1 is chiefly of interest because it reveals the impact of World War II upon the place of the United States in the international economy.

Before the war, in 1938, the United States had a strongly "favorable" merchandise account that more than paid for the negative service account. The investment income account was positive as the United States was already a creditor nation. Most of the relatively small aid and gifts item constituted immigrant remittances. On balance, the investment accounts had little impact. The most striking feature of the prewar situation after 1933 was the large annual purchase of gold by the United States Treasury which financed the "favorable" current account. These gold imports ran to about one and one half billion dollars nearly every year. Much of this im-

ported gold was newly mined and came from the Union of South Africa, Canada, and Australia; for these countries of the British Commonwealth, gold is as regular a merchandise export as cotton is for the United States and it is not surprising that they should agitate from time to time for a rise in the United States purchase price of gold (still \$35 an ounce). In some years gold imports were also received from the gold reserves of non-producing nations.

The year 1947 was one of reconstruction, especially in Europe. Foreign nations had suffered immense war damage and lost much of their shipping, Americans were not yet travelling abroad in large numbers as tourists, and European nations had had to sell many of their investments in America, thereby increasing the *net* investment income of the United States. The enormous positive current account was financed in various ways. The Congress voted for large sums for direct aid, for indirect aid through United Nations relief, and also provided money through the International Monetary Fund and the International Bank for Reconstruction and Development. American industry recommenced making direct investments abroad. And the world, especially the sterling area, increased its gold sales to the United States.

The movements of gold to the United States are almost entirely for immediate sale, for most foreign central banks prefer dollars to holding gold under earmark here. In fact the value of gold is determined more by its dollar price than is the worth of the dollar determined by its gold price. Inasmuch as the Treasury now owns more gold than all the jewellers in the country would use in a century, the continuance of the gold purchase policy is to be explained partly as an uneconomic but politic means of supplying the world with dollars with which to buy American exports. The producers of exports are pleased and various government agencies probably favored this popularly accepted way of financing the sterling area immediately after the war.

By 1954 (see Table 7.2) a more stable pattern had developed. A new feature was the large expenditures abroad by the United States military for goods and services, equal to about two and a half billion dollars, and more than enough to put the merchandise

account in balance. United States tourists were on the move again. And the investment income had risen (net) to over two billion dollars a year. Congress was still voting aid—only more for military than reconstruction purposes. Private direct investment abroad had become important. Two other features were the very considerable imports of raw materials and the slight net loss of gold used in settlement.

Table 7.1 also indicates that there was a considerable amount of long-term investment moving in opposite directions, to and from the United States, although this was far less prevalent than before the war. Simultaneous long-term lending and borrowing is not so unusual. In different countries there are different kinds of investment opportunities: thus an American may be investing in Canadian nickel producing mines at the same time that Canadians are investing in American motion picture studios. The urge for diversity and risk-spreading is universal among investors.

TABLE 7 2

UNITED STATES BALANCE OF PAYMENTS WITH SELECTED AREAS, 1954  
(millions of dollars)

	<i>Sterling Area</i>	<i>Canada</i>	<i>Latin American Republics</i>	<i>World</i>
Merchandise	+216	+501	-120	+2385
United States Military	-460	-192	-24	-2595
Travel	-99	+27	-100	-420
Transportation	+19	+1	+68	+221
Investment Income	+452	+442	+786	+2268
Current Account	+238	+957	+684	+2273
Aid & Gifts	-298	+2	-84	-2028
Direct Investment				
Private	-134	-626	-225	-1197
Private Long-Term Investment (other)	+106	+5	+51	+26
Official & Bank Loans at				
Long-Term	-10	-123	+52	+108
Private Short-Term Capital	-43	-3	-72	-156
Official & Bank Short-Term Capital	-198	+205	-122	+638
Gold	+50	-12	-69	+310

SOURCE: International Monetary Fund, *Balance of Payments Year Book*.

Table 7.2 is included because it indicates the place of the sterling area, Canada, and Latin America in the United States balance of payments while also giving a somewhat finer classification of United States payments with the world as a whole. It is noteworthy that most of the private United States investment abroad is now taking the form of direct investments (e.g., oil refineries, copper smelters, and wood pulp plants constructed by American companies) rather than as portfolio investments (e.g., an American investor buys the securities of a foreign corporation). United States military payments in the sterling area were more than double our net merchandise exports to it. The world wide current account credits were very nearly offset by the Aid and Gifts debits, so it seems that the United States taxpayers were largely financing the "export balance."

In many ways the balance of payments of the United States today indicates a rather extraordinary state of affairs. The excess of exports over imports is being largely offset by government aid and gifts and expenditures abroad by the United States military. It is the taxpayer who is financing the "favorable" trade balance. During the Napoleonic Wars, Great Britain regularly supported its allies on the continent while running an export trade balance. Much the same is happening again, a century and a half later, only now it is the American economy that is footing the bill in a cold war with the Soviet Union.

### **HOW WELL IS A NATION DOING IN THE WORLD?**

The balance of payments of a nation over a period of time can tell quite a story about its economic health vis-à-vis the rest of the world. Is it saving or dissaving, investing or disinvesting, hoarding or dishoarding internationally? Can the present state of its international financial affairs be expected to endure? Is its currency likely to come under increasing pressure?

### **CLASSIFICATIONS OF ACCOUNTS**

In the following analysis we shall refer to the accounts set forth in Table 7.3. The meanings of these basic accounts are clear

and have been described in the opening section of this chapter, but despite their usefulness official statistics do not always fit this ideal exactly. The algebraic sum of all the basic accounts must be zero, treating credits as positive and debits as negative, which is just another way of saying that the balance of payments must balance. Of more interest, however, is the relation of various groups of accounts to one another. As shown in Table 7.3, the basic accounts can be grouped in at least two different ways; that shown

TABLE 7.3  
CLASSIFICATION SYSTEMS OF BASIC ACCOUNTS IN A  
NATION'S BALANCE OF PAYMENTS

<i>For Analyzing Investments</i>	<i>Basic Accounts</i> Merchandise Trade (exports-imports) Services ("invisible" trade)	<i>For Analyzing Disequilibrium</i>
Savings Account	Balance of Trade ("visible" and "invisible") Income on Investments Aid, Gifts & Unilateral Transfers	Current Account
Investment Account	Long-Term Loans Direct Investments Short-Term Capital	Long-Term Account
Cash Account	Bank Deposits & Currency Gold	Short-Term Account

on the left is most useful for ascertaining whether a nation is saving, investing, or hoarding; that shown on the right is most useful in detecting signs of disequilibrium.

#### MATURE AND IMMATURE DEBTORS AND CREDITORS

Before the first world war, countries were often described as being debtor or creditor nations, and they were furthermore categorized as being immature or mature debtors or creditors.

Thus an immature debtor country was one that had an "unfavorable" (negative) balance, both as regards trade (visible and invisible) and investment income, but was able to sustain this state of affairs over a decade or more because the world was making long-

term investments in it. The United States was such a country during the early part of the 19th century. In time, however, if the long-term investments prove to have been justified, such a country becomes a mature debtor. It still owes money to the world but a favorable balance of trade provides the means both to pay interest and dividends and to commence repayment of the long-term loans. The United States had reached this position by 1914.

If a nation continues to have a favorable current account it will in time cease to be a debtor and become an immature creditor. The trade and investment income accounts are then both positive and the long-term investment account is negative—indicating accumulating investments in the rest of the world. Great Britain was in this position during most of the 19th century and the United States would be more markedly in this position today were it not for the large aid payments.

In time, established creditor countries may find their trade balance becoming unfavorable, while their ability and willingness to make further investments abroad declines. They then become mature creditors, using interest, dividends, and profits to finance an unfavorable balance of trade. This was Great Britain's status immediately preceding World War I. During both world wars she had to disinvest by selling many of her overseas investments. This reduced the annual income obtained from long-term investments and made it necessary to reduce the former excess of imports over exports.

This four-way classification system is simplicity itself. A nation is in the immature category if the trade balance and the income from investments balance have the same sign: it is in the mature class if these two accounts have different signs. A nation is a creditor if its income from investments account is positive: if negative, it is a debtor. Table 7.4 reveals Canada to be a mature debtor and the United States to be an immature creditor. The United Kingdom has experienced all four stages in the past but today does not fall clearly into any of the above categories.

There is, of course, no inevitable necessity that any one country will evolve through all these four stages.



TABLE 7.4

BALANCE OF PAYMENTS OF CANADA, UNITED KINGDOM, AND UNITED STATES  
IN 1954

	Canada <sup>a</sup>	United Kingdom <sup>b</sup>	United States <sup>c</sup>
Merchandise	+152	-192	+2,385
Government Transactions	+9	-121	-2,537
Travel	-80	-6	-420
Transportation	-40	+132	+221
Investment Income	-288	+35	+2,268
Other Goods & Services	-62	+319	+357
Current Account	-390	+167	+2,273
Aids & Gifts	-41	-7	-2,028
Private Loans (in banks)	+532	-145	-1,327
Official & Bank Capital & Gold	-101	-15	+1,045

<sup>a</sup> in Canadian dollars, millions.

<sup>b</sup> in pounds sterling, millions

<sup>c</sup> in United States dollars, millions.

SOURCE: International Monetary Fund, *Balance of Payments Year Book*.

#### NATIONAL WEALTH AND INTERNATIONAL SAVING AND INVESTING

The foregoing description of debtor and creditor nations, "mature" and "immature," can be integrated with more modern ideas regarding international saving, investing, and hoarding.

A nation must get along in the world in much the same way that a household gets along in the national economy. If it produces more than it consumes it is saving. And if it saves it can keep its savings in the form either of investments or money.

In the case of a nation, versus the rest of the world, it will be saving internationally if its Savings Account is positive; that is (see Table 7.3), if its Current Account and Aid Account taken together have a positive sum. These savings must take some form. Either the Investment Account (the sum of the long-term and short-term capital accounts) or the Cash Account (the sum of gold, bank deposit, and currency accounts) must be negative. If the Investment Account is negative the nation is enhancing its international creditor position or detracting from its international debtor position. If

the Cash Account is negative the nation is hoarding and becoming internationally more liquid. Algebraically, the Savings Account, Investment Account, and Cash Account must sum to zero, if the debit and credit conventions of the balance of payments are observed. This is equivalent to saying that a nation's international hoarding and investing must equal its international savings.

However, this does not tell the whole story about a nation's income and wealth. A country can be saving internationally but dissaving domestically: while its overseas investments increase its plant and equipment may be running down at home. We need also to know about production other than exports, about consumption other than imports, and about saving that does not take the form of increased foreign investments and balances.

#### **DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS**

The financial instability and depreciating currencies that have been so commonplace since 1918 have caused economists to place increasing emphasis on the analysis of what has come to be called balance of payments disequilibrium. This is a much shorter-run kind of analysis, than that regarding national saving and investing that has just been given. Sometimes the determination of disequilibrium requires a fair amount of detective work as to the facts, but the concepts are clear.

Essentially, a nation's balance of payments is in disequilibrium when the present state of the various accounts cannot be continued indefinitely. Non-sustainability is the key feature of disequilibrium. There are various kinds of situations that cannot be financed indefinitely and which, when detected by too many people, are likely to lead to a progressive weakening of the national currency.

Of course, in the long run, there must be some disquiet if a nation, year after year, finances a negative current account from the sale of its long-term foreign assets, for this cannot go on indefinitely. The converse case, where foreigners are investing at long term in a developing economy which has an unfavorable current account, need cause no alarm; if these investments are well made the balance

of trade will become positive in time. In general, though, the concept of balance of payments disequilibrium is not commonly applied by economists to cases where the current and long-term accounts practically offset one another.

It is when the current and long-term accounts are together negative, and especially when it is an unfavorable current account that is the cause of this, that disequilibrium may be diagnosed. It is then said that the *payments balance* is adverse. The significance of this is that there must be a drain on the short-term account and the various items that comprise this account—short-term capital, currency and bank deposits, and gold—*may* be insufficient to meet this drain for very long.

For example, the gold reserves of most central banks are severely limited, and so if gold sales are financing the negative payments balance the situation is unsound: of course, in the case of a nation like the Union of South Africa, gold is an export and should be treated as part of the trade balance, but this is an exceptional case.

Similarly, it is hard to maintain a positive short-term capital account over a period of years, and so finance the negative current and long-term accounts. Short-term capital invested abroad is usually soon exhausted and sometimes in these days of exchange control the proceeds of sales cannot be repatriated and may be blocked. To some extent foreigners may be induced to make short-term capital loans to the home country, in response perhaps to a rise in the central bank's interest rate offer, but owners of short-term capital are a suspicious lot who easily take flight.

The international sale of currency and bank balances is at best usually a short-lived stop gap, because it is unusual for corporations and financiers long to deny themselves the interest rate that can be earned on short-term capital investments.

Nowadays, because of receipt of government aid, a number of countries have a negative current account plus long-term investment account, and yet their payments balance is neutral because of the positive aid account. There is then no immediate pressure on the short-term accounts and so in a formal sense there may be no

disequilibrium. Practically, though, a nation's situation is hardly an assured one if its continuance depends on the annual support of foreign governments who must in turn obtain annual appropriations from their legislatures for this purpose. It is realized abroad, for example, that during an election year Congress may consider foreign aid in a more dubious spirit.

In seeking to detect disequilibrium in a nation's balance of payments, it is sometimes useful to attempt a distinction between autonomous and induced transactions. In the absence of exchange-control restrictions, the merchandise trade account of a nation depends upon millions of transactions by importers and exporters, all of which depend, in turn, not upon the international balance of payments but upon such basic things as geographic specialization of production, consumer tastes, and transportation costs. These transactions are not induced transactions because they are not occasioned by the condition of any other accounts in the balance of payments. This also tends to be true of capital transactions. In the absence of exchange-control restrictions, international long-term investors place their funds according to risk, expected rates of return, knowledge, demand for capital, and so forth. Such loan transactions depend upon the relative economic development and resources of different nations and not upon the state of the national balance of payments. Hence, they are not induced, either, and are called "autonomous" transactions.

If all the autonomous international transactions of a nation exactly balanced, there would be no induced transactions, and the balance of payments would be in stable equilibrium. For example, if a nation's natural tendency to run a negative (or so-called passive) current account is exactly offset by the natural tendency of foreign lenders to accord it an active (or positive) long-term investment account, no short-term capital movement is needed to effect settlement. A nation's balance of payments will be in stable equilibrium when there are no net induced transactions; or when all the autonomous transactions exactly offset one another, which amounts to the same thing.

Short-term capital transactions are usually induced and so any large and sustained outflow of these funds constitute a danger signal.

In actual practice it is often difficult (short of cross-examining the persons involved) to know which transactions are autonomous and which induced. Also it is sometimes a matter of opinion as to whether certain transactions can be repeated again and again in the future. Hence, when there are free exchange markets, the simplest test of stability in a nation's balance of payments is probably the state of its short-term capital accounts. If these are collectively positive—indicating that its short-term loan, money, and gold transactions are on balance sales rather than purchases—the balance of payments is then unfavorable. This in turn means that its current account and long-term investment account do not offset each other and there is not true equilibrium.

The balance of payments of a nation suggests instability (i.e., disequilibrium) if (1) there is a negative balance for all autonomous transactions; (2) certain important and "favorable" transactions can hardly occasion large credits indefinitely, or (3) the balance of payments is unfavorable as evidenced by the sale of liquid assets such as bills of exchange, bank balances, and gold.

### **EXCHANGE CONTROL AND ARTIFICIAL EQUILIBRIUM**

Most of the nations of the world have resorted to exchange control in the belief that they would otherwise suffer an insupportable gold and foreign exchange drain. One essential feature of exchange control is that a resident cannot acquire foreign exchange, in order to import goods or make foreign loans, without government permission. In these and other ways, exchange control has been used to bring balances of payments into a kind of artificial stability and equilibrium.

The existence of exchange control has the effect of splitting each account of the balance of payments into two parts: local currency and foreign exchange.

Most exchange controls follow a policy of keeping their gold and foreign exchange reserves at an almost constant level; they do not permit them to fall below a minimum safety level, and their desire for imports usually prevents them from amassing larger reserves. Hence aggregate foreign exchange debits and credits on current-account and investment account transactions usually tend to balance.

In the case of local currency debits and credits, the exchange control is usually very content that foreigners acquire local bank balances, so that the country can buy, in local currency, more merchandise, investments, and gold than it sells in local currency. However, foreigners usually do not want any more local currency balances, and the exchange control will not sell its gold reserves for local currency. Hence, in practice, the local currency gold and money accounts usually have net balances approaching zero, and the aggregate local currency debits and credits on current-account and investment account transactions together tend to balance.

The outcome of exchange control is often an artificial stability in the balance of payments as a whole. The current account and investment accounts tend to cancel on the foreign exchange side, the limiting factor being the credit or sale transactions which can somehow be made. The current account and investment accounts tend also to cancel on the local currency side, the limiting factor being the purchase transactions that can be financed. The difficulty is to get foreign exchange credits (which means exports in the face of competition and borrowing from abroad) and local currency debits (which means persuading foreigners to exchange their goods and I.O.U.s for overvalued local currency). In any event, if the exchange control is sufficiently complete and strict, the permitted international transactions will not be unfavorable in the aggregate and the balance of payments situation is sustainable.

Exchange control can prevent a complete breakdown, but it cannot eliminate a condition of disequilibrium. The Control forces a balance in a sustainable manner. (Even a drugged man can stand up if he is laced in a strait jacket and leaned against a wall.)

A nation's balance of payments can be propped up almost indefinitely through exchange control. Whether the situation is economically healthy is of course another matter.

### PROBLEMS

1. "The *balance of payments* is misnamed if the receipt of money from a foreigner has to be treated as a debit." *Explain.*
2. "There is a lot of detective work needed to determine, from a nation's balance of payments, whether it is in a condition of stable equilibrium." *Explain.*
3. "There's not much in a nation's balance of payments that has to balance—the global current account credits and debits needn't balance and total debits and credits with any one other nation needn't balance." *Evaluate.*
4. "For some nations gold transactions should be in the trade account and for others they should be in the short-term account." *Explain.*
5. "There are many synonyms for an 'export' trade balance." *Exemplify.*
6. "How can one tell whether an export is a gift or really an export?" *Explain.*
7. "There is no need for Nation X to continue its present system of strict exchange control: why, its own statisticians show that its balance of payments is in equilibrium, with the current account in almost perfect balance." *Evaluate.*
8. "A country's balance of payments situation must be interpreted in part in the light of its international reserves; thus, Britain's prewar reserves were equivalent to over 9 months' imports into the United Kingdom whereas they are now the equivalent of less than 3 months' imports—and in relation to the total imports of the sterling area, which is what matters, they are still lower." *Explain.*
9. "Some countries estimate their balance of payments a year in advance and allocate exchange on the strength of the estimate; but they are making a lot of assumptions when they proceed on such a basis." *Explain.*
10. "The Soviet Union's balance of payments is based on sound values in contrast to, say, the American version, and hence is an authentic measuring rod and not one propped up by artificial devices such as foreign economic and military aid and catch-all categories such as 'errors and omissions.'" *Evaluate.*

11. "How may we view the small surplus in Britain's current balance of payments, given the vast turnover of total payments and the inevitable 'errors and omissions'? We must claim only that in the balance of payments Britain about broke even, if we wish to make a safe generalization in terms of this imperfect product of the statisticians' art." *Explain.*



## CHAPTER 8

# Making International Payments

One of the building blocks which we use in constructing the edifice of the international economy consists of foreign payments. This building block, to which occasional reference has been made in earlier discussion, differs significantly from its counterpart, domestic internal payments, and hence we must now describe it in some detail. International settlements are more complicated than payments for domestic transactions because the payer and payee are residents of different countries, each having distinct currencies. A number of specialized techniques for making international payment have been developed over the centuries. It is to a discussion of the most important of these that we turn in this chapter.

### THE MEANING OF FOREIGN EXCHANGE

Foreign exchange is a collective term that includes all kinds of negotiable claims expressed in a foreign money. The foreign trader or financier is interested in particular kinds of foreign exchange, such as sterling, franc, or lira exchange. An American investor who is purchasing British securities in London will have to pay for them in sterling, and hence will purchase sterling exchange in order to discharge his liability. Specifically, he will attempt to buy (with dol-

lars) sterling bank balances, trade acceptances drawn in sterling, or perhaps sterling money itself. These various kinds of sterling exchange come into existence in different ways and must usually be purchased from different sources.

### FINANCIAL PAYMENTS

Leading American banks will normally maintain a demand deposit with a *correspondent* bank in London, another in Rome, a third in Mexico City, and others in the financial centers of all important countries. These bank balances, which are owned by the American bank, are the equivalent of sterling, lire, pesos, and so on. Conversely, foreign banks hold balances with correspondent American banks, such as the Chase Manhattan Bank of New York. American banks undertake foreign exchange operations whenever they sell these foreign balances for dollars, or add to them by purchasing foreign claims for deposit in these same foreign accounts.

#### PURCHASE OF A FOREIGN BANK DRAFT

The most direct method of obtaining foreign exchange is to walk into a bank and purchase a foreign bank draft. If a United States resident wants lire to remit to relatives in Italy for Christmas, he can use dollars to buy a lira draft, which is essentially an order to pay, from his local bank. It is drawn by the American bank upon its Rome correspondent and will be made out in favor of the party designated by the purchaser of the draft. In effect the American bank is writing a check on its Rome account and selling this check to a United States resident. The bank draft in this case calls for payment in lire and is sold for dollars, and so a foreign exchange transaction has taken place. The dollar price of the lira draft will be based on the prevailing exchange rate, after which a service charge will be added by the bank.

The dollar price of bankers' sight drafts on Rome can be considered the prevailing exchange rate for lire. However, the Ameri-

can bank will sell its Rome balances at a slightly higher price if the remitter is in a hurry, or at a lower price, if he will wait for his lire.

The quickest way to obtain lire is to purchase a cable transfer from the American bank, which will then wire its Rome correspondent to make certain payments. Cables always cost a little more because, apart from an extra charge for telegraphing, the bank balance must actually be in Rome the moment it is sold. This is not so in the case of a sight draft because the latter cannot be presented for several days. In the meantime the American bank need not cover its draft, and can be earning a small interest return in Rome through investing in short-term paper, or call loans. This consideration is less important today than before the advent of trans-Atlantic airmail.

On the other hand, the American bank might sell a time draft, in which case the order to pay will not become effective for 30, 60, or 90 days. Drafts of this kind must obviously sell at a discount because the bank is receiving dollars now from the purchaser, but will not have its Rome balances debited for at least one to three months. This discount is based on current interest rates in the money market.

#### **SALE OF FOREIGN CLAIMS TO A DOMESTIC BANK**

People often receive payment in foreign funds. An American investor who has bought securities of the British Aluminium Company Ltd. will be paid any forthcoming interest or dividends in pounds sterling. These will probably be received in the form of a check drawn by the British metal company on its London bank. The United States investor will probably sell this sterling check to the foreign exchange department of his local bank and obtain the appropriate number of dollars minus a service charge. The local bank will collect through its correspondent bank in London. The American bank has reduced its dollar holdings and has augmented its sterling balances in Britain.

### PAYING FOR MERCHANDISE

Several special methods have been developed for making merchandise payments. One reason for this is that the shipper usually refuses to release control of the goods he is selling until the importer accepts financial liability. In most cases the initiative is taken by the exporter, who is naturally the most interested in ensuring collection, and the agreed-upon price is expressed in the seller's money. In certain cases, however, the selling price may be contracted in the importer's currency, and occasionally the importer may take the first steps to effect a settlement. In each instance the technique of making payment must be varied to suit the circumstances.

#### THE DOCUMENTED BILL OF EXCHANGE

One of the oldest procedures of obtaining payment for exports is for the shipper to draw a bill of exchange upon the foreign buyer. A bill of exchange is an order to pay. The drawer (exporter)

NO 5478

San Francisco, Calif. June 18, 19\_\_

AT 60 Days SIGHT OF THIS FIRST BILL OF EXCHANGE (SECOND UNPAID)

PAY TO THE ORDER OF Doe and Roe

FIFTY FIVE HUNDRED U. S. DOLLARS ONLY

U. S. Dollars \$1500.00

VALUE RECEIVED AND CHARGE TO ACCOUNT OF Invoice 123

TO Ecuador Import Company, Lima, Peru

SAN FRANCISCO EXPORT COMPANY,  
By John Doe

Deliver Documents only upon

Figure 8.1

instructs the drawee (importer) to transfer the face value of the bill according to the instructions of a designated payee (possibly some bank to which the drawer sells the bill). A bill is hardly negotiable

until the drawee has admitted the liability asserted in the bill. This admission of liability occurs when the bill is presented to the drawee and he accepts it by writing *accepted* across the width of the bill, whereupon the bill becomes *two-name paper* and can be readily sold.

There are various kinds of documentary bills, or drafts. American exporters normally bill their customers in dollars, and so the bills they draw are called *dollar drafts*. Occasionally, in the case of shipments to leading countries such as the United Kingdom, the American exporter of tobacco or cotton may draw the bill in sterling, in which case it is a *sterling draft*, and will probably find its way on to the London bill market via an American bank. Documentary bills differ as to the time of payment. *Sight bills* must be paid within a day of presentation. *Time drafts* call for payment in 30, 60, or 90 days, as indicated on the face of the bill. (Fig. 8.1 depicts a typical time draft.)

The importer cannot obtain physical possession of the goods that have been shipped to him until certain documents, such as the *bill of lading* and *marine insurance receipts* that were originally attached to the bill, are released to him. A *documentary acceptance draft* (or *D/A draft*) calls for release of these documents to the importer upon his acceptance of the bill. But a *documentary payments draft* (or *D/P draft*) provides for effectual release of the goods only upon actual payment by the drawee. Practice naturally varies according to the countries and commodities concerned. The *D/A draft* is generally used for exports to Latin America. However, exporters try to use the *D/P draft* in the case of shipments to southeastern Asia and other regions where there is risk of non-payment.

It should be emphasized that the exporter, who draws the bill in the first place, does not hold it through the entire procedure of acceptance and eventual payment. He will probably sell it to his bank or through a bill broker to some person wishing to invest funds at short term. The drawer does not normally obtain the full face value of the bill. A time draft is naturally discounted as an interest charge.

Sometimes there is a charge for currency exchange also. If an American exporter to Britain draws a sterling draft and he sells this bill to his local bank, he is disposing of pounds sterling for dollars. The bank will make a small charge for this additional service of selling dollar balances in exchange for increased deposits in London.

The documentary bill of exchange is falling into relative disuse. The shipper does not have a negotiable instrument until the drawee has accepted the bill, and there is an inevitable delay before presentation can be made. A more important consideration is that a documentary bill of exchange, even a sight draft, that has been accepted by a fairly obscure importer may have to be disposed of by the drawer at a special discount because of the credit risk. These defects have led to an increasing use of bankers' bills authorized by a letter of credit.

#### **THE IMPORT LETTER OF CREDIT**

A common procedure nowadays for making payment on a foreign trade transaction is to have the importer take the initiative by arranging for his bank to send an import letter of credit to the shipper. This letter of credit obligates the importer's bank to accept or honor drafts (bills of exchange) which are presented to it, provided these bills of exchange are accompanied by prescribed documents. The foreign exporter, who receives this guarantee from the importer's bank, can now rely upon the credit of the bank and of the importer. The exporter will then draw a bill on the importer's bank and should have no difficulty in selling this draft.

For example, a New Jersey importer might go to the Chase Manhattan Bank of New York and request this bank to open a letter of credit in favor of Señor Ortiz, a Chilean exporter of hemp. By this act the Chase Manhattan Bank undertakes to honor Ortiz' drafts if the drafts are drawn under the credit and are presented before a given date accompanied by ocean bills of lading to the order of the New Jersey importer, and by Ortiz' invoice

for  $x$  tons of hemp. The Chase Manhattan Bank has pledged its credit; therefore it must consider the risk and the security. The risk is the reliability of the New Jersey importer, and the security is the merchandise involved. The New Jersey importer is expected to pay eventually for the goods: the Chase Manhattan Bank merely underwrites the transaction in the role of guarantor and intermediary.

The mechanics of payment involve several steps. (1) Upon shipment, the Chilean exporter draws a bill on the Chase Manhattan Bank rather than on the importer. (2) He sells this draft to his local bank for pesos at a discount. (3) The Chilean bank forwards the draft, documents, and instructions to its correspondent bank in New York. (4) The correspondent presents the draft with documents to the Chase Manhattan Bank for acceptance. (5) The Chase Manhattan Bank transmits the shipping documents to the importer in order that he may obtain the merchandise from the transportation company. (6) The correspondent bank undertakes collection from the Chase Manhattan Bank on behalf of the Chilean bank when the draft matures. (7) The Chase Manhattan Bank, in accordance with the agreement under which it originally opened the letter of credit, is repaid by the importer.

As a result of this series of operations, the importer obtains credit and finally pays in dollars; the Chase Manhattan Bank earns a commission for having opened the letter of credit; the correspondent bank makes a charge for acting as a collection agent; the Chilean bank earns the discount on the funds which it advanced; and the exporter receives immediate payment in pesos. It is also noteworthy that the Chilean bank now holds more dollar assets, which are deposited with its New York correspondent, but has reduced peso balances. A foreign exchange transaction has taken place. Figure 8.2 depicts a typical letter of credit of the irrevocable type.

#### THE EXPORT LETTER OF CREDIT

A reverse variation of the above procedure is afforded by the *export letter of credit*. In this case the exporter is paid locally by

AIRMAIL

August 14, 19--

Banco Hispano Americano,  
Barcelona, Spain

Subject: Our Irrevocable Letter of Credit No 12345

Gentlemen:

We confirm our cablegram of today, wherein we requested you to advise the SPANISH EXPORT COMPANY, Reus, Spain that we have established our Irrevocable Credit No. 12345 in their favor, for account of the SAN FRANCISCO IMPORTING COMPANY, San Francisco, for the sum of TEN THOUSAND SEVEN HUNDRED TWENTY FIVE U.S. DOLLARS (\$10,725.00), available by drafts at SIGHT on the Bank of America N.T.&S.A., San Francisco, to be accompanied by the following documents in duplicate at least:

Commercial Invoice evidencing 2-1/2% discount, covering TEN THOUSAND (10,000) kilos prime TARRAGON, SEEDLED FILBERTS, Crop 19-- in bags marked "Produce of Spain" at \$10.00, less 2-1/2% discount, per kilos, C. & F. U.S.A. Atlantic or Gulf.

Other documents required:

Consular Invoice  
Full set of clean on board Bills of Lading, to order of shipper, blank endorsed, marked freight prepaid, also marked "Notify SAN FRANCISCO IMPORTING COMPANY, San Francisco," evidencing single shipment, by direct Portuguese or Spanish steamer, during the month of August, 19--

Shipment from Lisbon, Portugal to any U.S.A. Atlantic or Gulf Ports  
Insurance to be effected by the buyers. Part shipments are not allowed.

This credit is covered by U. S. Treasury License 87-67890.

Drafts drawn under this credit must be marked: "Drawn under Bank of America N.T.&S.A., San Francisco, Irrevocable Credit No. 12345 dated August 14, 19--."

We hereby engage with drawers, endorsers and bona fide holders of drafts drawn under and in compliance with the terms of this credit, that same shall be duly honored on presentation, if accompanied by documents as specified. This credit expires September 10, 19--.

Yours very truly,

W. L. Guthrie,  
Assistant Manager

Figure 8.2

an agent of the importer's bank upon presenting evidence that shipment has been made. Bills drawn by the exporter under this method are domestic sight drafts.

We shall suppose that Señor Perez of Chile wishes to buy some locks from the Safety Lock Company of New Jersey. A contract



is signed as a result of correspondence between Perez and the Company. This contract contains a provision that payment will be provided by an export letter of credit. Perez will take the contract to his local bank in Chile and inform the bank as to the nature of the deal, the amount to be paid, the merchandise to be shipped, the documents required, and the expiration date. All this is required so that the letter of credit can be established to conform to the terms of the contract between Perez and the Safety Lock Company. When this has been accomplished, Perez' bank in Chile will write or cable its correspondent bank in the United States, instructing it to advise the Safety Lock Company of the establishment of the letter of credit and its terms.

The export credit, in this case, is a contract between Perez and his local bank, and is distinct from the purchase agreement between Perez and the Safety Lock Company. The letter of credit binds Perez' bank to accept bills that are presented to its correspondent bank in the exporter's country. However, this commitment is qualified as to duration, type of merchandise, and total value. It is generally stipulated that the draft be accompanied by shipping receipts and other documents to prove that shipment has been made and in order that Perez' bank might acquire physical control of the goods. Naturally this obligation of Perez' bank is far more valuable to the exporter if it is legally reaffirmed by the correspondent bank in the United States. Or the American correspondent could issue its own irrevocable export letter of credit.

Under the arrangement here being described, the Safety Lock Company draws documented domestic sight drafts upon the Chase Manhattan Bank and receives dollars. The Chase Manhattan Bank debits the account of the Bank of Chile and forwards to the latter the relevant shipping documents. The Chilean bank will hand Perez these documents, which give title to the merchandise, when he comes in to make a settlement. As a rule a Latin American importer will pay his bank about 25 per cent of the peso cost of the dollars, and will sign notes carrying 6 or 7 per cent interest for the balance. These notes are usually not paid off until the imported goods have been sold. The importer's bank reduces

its dollar assets in America immediately and eventually improves its peso position in Chile.

#### DOMESTIC PURCHASE OF A FOREIGN TRADE BILL OR BANK DRAFT

An exporter will sometimes sell on *open account*, in which case he will mail the shipping documents to the importer prior to any payment or definite obligation. It is unusual to release goods in this way because the exporter runs the risk of default and his working capital requirements are increased. Presumably the importer will effect payment and is to be trusted, in which case the importer may purchase a bank draft from his local bank, drawn on a correspondent bank in the exporter's country. Or the importer may buy a duly authorized and/or accepted foreign trade bill drawn in the exporter's currency. Drafts of this kind are almost the equivalent of foreign money for certain purposes.

Suppose that an American importer ( $I_A$ ) has to pay a British exporter ( $E_B$ ) in sterling, and that concurrently, an American exporter ( $E_A$ ) is billing a British importer ( $I_B$ ), who has contracted a purchase in sterling. An economical short-circuiting of the banks now becomes possible.  $I_A$  can use dollars to buy  $E_A$ 's sterling bill and subsequently instruct  $I_B$  to make his sterling payment to  $E_B$ .  $E_A$  may have drawn the bill on  $I_B$ 's bank in Britain, and such a bill will find a readier market. If purchased by  $I_A$ , instructions will then be given  $I_B$ 's bank to pay  $E_B$  the amount of the bill. The two Americans buy and sell in dollars. The two Britons, in like manner, handle only sterling.

This latter method is economical because it avoids the foreign exchange charges made by banks for converting currencies. However, there is some expense and often considerable inconvenience. Exporters who draw bills are not acquainted with importers who wish to purchase them, but bill brokers make this their business, and usually charge one-eighth of 1 per cent for the service of bringing the parties together. The importer will be unable to buy sterling bills exactly totalling his indebtedness in Britain: he may have to cover a small balance by purchasing a draft from a bank

on its foreign correspondent. However, if the importer has a steady business of buying from Great Britain, he will probably keep an account with a British bank. The proceeds of sterling bills will then be paid into this account, and he will write checks against it in the customary manner when he has payment to make in the United Kingdom.

#### **SETTLEMENT THROUGH A THIRD CURRENCY**

Although most of the foreign trade of the United States is financed in dollars nowadays, this has not always been so. Before World War I, for instance, most of our trade was financed in sterling through London. In many parts of the world today foreign trade is not always carried on in the money of either the exporter or the importer, which is especially true if their respective currencies are of fluctuating value or if their countries participate in international trade to only a minor extent. For example, a shipment of rabbit skins from a French collector to a Belgian manufacturer of hat felt might be transacted in dollars. The Belgian importer provides dollar exchange by writing a check on a deposit he keeps in New York, arranging for his local bank's New York correspondent to accept drafts drawn upon it by the French exporter, or by purchasing dollar bank drafts or trade acceptances. The French skin collector will have no difficulty in disposing of dollar exchange. A surprising proportion of the trade of small nations, especially where the businessmen concerned must resell or repurchase in foreign markets, has always been transacted in a few key currencies, such as sterling or United States dollars today.

#### **EXTRAORDINARY GOLD TRANSFERS**

A decade or so ago, when gold was still unrestricted, very large financial transfers were sometimes effected through gold shipments. If a London bank wished to make an extraordinary shift of funds to New York, it might sell sterling to the Bank of England for

gold, ship the gold to New York, and sell the gold to the United States Treasury for dollars. Such transactions require unrestricted gold movement and an assured buying-and-selling market for gold in the exporting and importing countries respectively. These conditions have not existed since before World War II.

### HOW IMPORTS HELP TO FINANCE EXPORTS

The above description of alternative ways of making international payments underlines once again the offsetting character of a nation's exports and imports. In the majority of cases our exporters seek payment in dollars under the terms of export letters of credit opened in favor of American sellers by foreign importers, or on the basis of dollar drafts drawn by American sellers on foreign buyers. Foreigners thus have to have a source of dollars if they are to be able to do their financing in dollars. At bottom it is our importers who are the foreigners' source of dollars. We pay foreigners for our imports with checks on American banks, and foreigners in turn use the dollar balances so acquired to pay for our exports. When trade is flourishing on a sound basis, dollar balances shift back and forth between American importers and American exporters to lubricate the wheels of mutually advantageous commerce.

Our exporters in some cases seek payment by drawing bills of exchange against foreign customers or upon importers' banks, but payment is actually not received until the bills are sold. There are two principal kinds of draft purchasers. One is the United States importer who can meet obligations to French, German, and other exporters by buying franc, mark, and other foreign bills. If it were not for the existence of these American importers, a very large part of the market for foreign bills drawn by United States exporters would vanish. Our exporters in many cases are thus paid by our own importers.

American banks are the other principal buyers of bills drawn by exporters in this country. In this way American banks increase their balances with correspondents abroad and reduce their dollar

holdings. Essentially our banks are buying foreign exchange with dollars when they discount a foreign draft or bill made by an American exporter. These foreign balances are part of the stock in trade of American banks and would not be bought if there were not other people to whom they could be sold. Who buys drafts of American banks on foreign correspondents? Some United States importers, because they have to pay for the goods bought abroad. Some United States investors (importers of evidences of indebtedness), for another, because they have to pay for foreign securities purchased abroad with foreign funds. In these cases again it appears that our exporters receive payment from American importers of all kinds.

The international transactions which cause increases and decreases in American-owned balances held abroad deserve closer scrutiny. How does a New York bank (NY) change its balance with its correspondent bank (L) in London? Transactions with United States residents will have the following consequences:

#### NY's Balance with L

##### Increased by

Buying sterling bills from exporters;  
 Buying sterling checks from:  
   investors in British securities (for interest),  
   sellers of securities held abroad,  
   all others receiving payment from Britain.

##### Decreased by

Sale of sterling bank drafts to:  
 importers,  
 purchasers of securities held abroad,  
 immigrants making remittances,  
 all others wishing to make payment in Britain.

These repleting and depleting transactions will not balance over short periods except as a result of conscious policy on the part of the New York bank.

If the tide of international payments is flowing toward the United States from Britain, it is likely that L's balance with NY will decrease. Sooner or later L will become worried because the

funds held with NY are becoming dangerously low. There is excessive demand in the United Kingdom for dollar drafts on NY, as is evidenced by the condition of the nation's balance of payments. How can L's balance with NY be increased?

One possibility is that NY might decide to hold larger balances with L. NY is probably L's New York correspondent if L is NY's London correspondent. However, the condition of the balance of payments which accounts for the decline in L's NY funds is probably increasing NY's sterling balance with L. Therefore, NY will probably be unwilling to hold further balances with L.

Unless the balance of payments shifts again in the opposite direction of its own accord, the eventual solution is what amounts to a change in the dollar-sterling rate of exchange. NY will have to buy fewer sterling bills in New York and sell more sterling drafts on L by lowering the dollar prices of both. Simultaneously L will attempt to buy more dollar bills in London and sell fewer dollar drafts on NY by raising the sterling prices of both. This cheapening of the pound should encourage residents of the United States to import more goods and securities from Britain and to export fewer. As the adjustment continues, it will become increasingly evident that our exporters of goods and securities receive payment for their sales because of the expenditures by United States importers of goods and securities.

### PROBLEMS

1. "The pattern of worldwide correspondent relations does much to facilitate international payment." *Explain.*

2. "The rate for a sight draft is generally less than that applicable to a cable transfer, while a time draft usually is quoted below the sight rate." *Explain.*

3. "When American exporters use D/P terms on sales to some foreign areas and D/A terms on sales to other areas they are guilty of the rankest international discrimination." *Evaluate.*

4. "Since trade drafts involve the names of the parties to commercial transactions, while bankers' drafts bring banks into the picture,

it stands to reason that the participation of bankers in financing increases the cost of doing an export business." *Evaluate.*

5. "A United States export financed by an import letter of credit opened abroad for the importer represents a transaction in which credit is advanced by a foreign party." *Explain.*

## The Rate of Exchange

There are about 50 different national monies in the world today, although three-quarters of the world's trade is contracted in terms of dollars or sterling. Each of these foreign currencies has a dollar price, or exchange rate, in New York. Thus a rate of 2.80 on London in New York means that the dollar price of a British pound is currently \$2.80 in the United States. Numerous exchange rates are quoted in New York at any given moment, and Table 9.1 gives a selected few. There are always a number of different national currencies being bought and sold there. If all their prices fall together, the dollar is appreciating; but if only the rate on London fell, it would indicate a depreciation of the pound sterling. Since exchange rates are prices, they are directly determined in the market by the international demand for and supply of currencies, and ultimately by the forces summarized in the balance of payments.

### A STRUCTURE OF EXCHANGE RATES

Strictly speaking there is no single foreign exchange rate prevailing in New York. As described in the preceding chapter, there are several different kinds of instruments that an American importer might use to pay his British supplier. Under certain circumstances the American importer might buy a sterling cable transfer, a sterling sight draft, and so on. All these instruments of payment



are denominated in sterling and so comprise special kinds of sterling exchange.

In the case of New York rates on London, the dollar cost of a sight draft on a London bank is perhaps the most important single sterling rate. Time drafts of all kinds naturally sell for a little less

TABLE 9.1  
PAR DOLLAR PRICES OF SELECTED FOREIGN CURRENCIES  
(December, 1956)

<i>Country</i>	<i>Unit</i>	<i>Par Price in Cents</i>
Australia	Pound	224.0
Austria	Schilling	3.8
Belgium	Franc	2.0
Brazil	Cruzeiro	5.4
Burma	Kyat	21.0
Canada	Dollar	100.0
Ceylon	Rupee	21.0
Denmark	Krone	14.6
Egypt	Pound	287.0
France	Franc	.28
Germany, West	D. Mark	23.8
Greece	Drachma	3.33
India	Rupee	21.0
Italy	Lira	.154
Japan	Yen	.278
Mexico	Peso	8.0
Netherlands	Guilder	26.3
Sweden	Krona	19.3
Switzerland	Franc	23.4
Turkey	Lira	35.7
United Kingdom	Pound	280.0

\* The par value is often meaningless as Exchange Controls frequently buy and sell at prices that differ from the par value, and black or "free" market prices vary far more; thus in December, 1956 the Turkish lira could be bought in the "free" market for 11¢ or less.

SOURCE: International Monetary Fund, *International Financial Statistics*.

than sight drafts. A trade bill will normally sell for less than a bank draft because of the greater risk. Incidental charges are also a consideration. A bill broker usually charges one-eighth of 1 per cent, a bank's service charge for its draft is likely to be one-fourth of 1 per cent, and the cost of cable transfers is slightly higher because of the telegraph cost involved. The domestic prices

of these different kinds of foreign exchange, denominated in the same national currency, tend to rise and fall together.

Throughout the present chapter, the rates of exchange with which we shall be concerned are primarily those that prevail between bank balances in different countries. Moreover, it will be temporarily assumed that these bank balances are freely transferable by their owners. What then will determine the cost in New York bank balances of acquiring London bank balances?

### **INCONVERTIBLE PAPER CURRENCIES**

The immediate determinant of exchange rates between two national currencies is the market offers of bank balances in one country for bank balances in the other. Certain general principles which apply in the case of inconvertible paper currency may be stated in a more particular way when there is unrestricted sale and purchase of gold at fixed currency prices. However, inasmuch as no nation in the world is unequivocally upon a gold standard, the following discussion stresses the case of inconvertible paper currencies.

#### **THE FOREIGN EXCHANGE MARKET**

Inconvertible paper currencies exchange at rates that equalize their demand and supply in the foreign exchange markets of the world. National currencies are valued internationally like any other commodity. An exchange rate is nothing more than the price of one money in terms of another. An increase in the demand for a particular money will tend to increase its price, whereas an increase in its supply will tend to decrease its price. These principles should be familiar to any student of elementary economics.

Let us consider the exchange rate between the United States dollar and the pound sterling by way of example. In New York part of the foreign money market deals in pounds sterling. There are dealers eager to sell pounds for dollars, and their offers con

stitute a sterling-supply schedule. There are other dealers eager to buy sterling with dollars, and their bids constitute a sterling-demand schedule. These two schedules are shown in Figure 9.1 (left diagram) where the horizontal axis is quantity measured in pounds sterling and the vertical axis is price expressed in dollars. Simultaneously, there is a dollar market in London, as shown in the right diagram, with axes reversed.

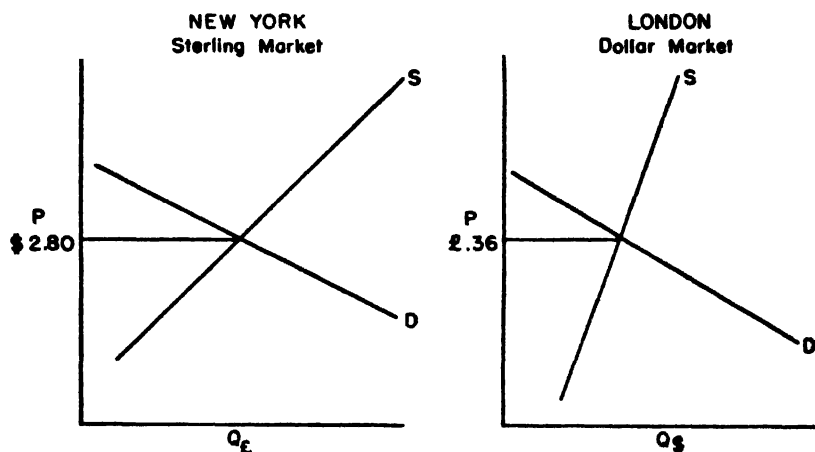


Figure 9.1

The equilibrium dollar price in the New York sterling market is that which equates the number of pounds offered and demanded. In the figure this is assumed to be \$2.80. Similarly the London market for dollars will be in equilibrium only at a sterling price that equalizes the number of dollars offered and demanded. This is assumed to be £.36.

The sterling price for dollars in London must be the reciprocal of the dollar price for sterling in New York. Arbitrage operations of foreign-exchange dealers will ensure it. Suppose the pound were priced at \$3.00 in New York and the dollar were priced at £.40 in London. Both these prices would be too high. Dealers will then sell dollars in London, resell the sterling proceeds in New York, resell the dollar proceeds in London, and so on until there is no

longer any profit opportunity remaining. The effect of these sales is to shift the supply schedules in both markets to the right and thus lower the quotations in both markets also. Reciprocal rates must finally result; thus \$2.80 is the reciprocal of £.36.

The New York sterling market and the London dollar market really constitute a single combined market. They are separated because of spatial necessity: trading cannot go on in the middle of the North Atlantic. However, it is more convenient to treat these markets separately, and this is perfectly valid as long as the price quotations in the two submarkets are always reciprocals of one another.

If exchange rates are to be understood, it must be recognized that the demand for another currency is largely a derived demand. A person does not buy pounds because he likes pounds, but because he wants to do certain things which can only be done if he owns pounds. If pounds were used solely to pay for the import of goods from Great Britain, the elasticity of the demand for pounds would be based upon the price elasticity of foreigners' demand for British goods.

#### THE PURCHASING POWER PARITY CONCEPT

When exchange rates have been very chaotic, as they were after both World Wars I and II, attempts have sometimes been made to determine the approximate value of one currency in terms of another by reference to their *purchasing power parity*. The crudest viewpoint is that if a given set of French produced goods costs about 400,000 francs in France, and the same set of goods produced in the United States costs about 1,000 dollars there, then one dollar must be worth about 400 francs. This approach has the merits of recognizing that demands for foreign exchange are largely derived demands for imports, and that buyers in every country will always prefer equivalent imports to domestic goods if cheaper. This rivalry between foreign and domestic goods will supposedly make the exchange rate between two currencies equal to the ratio of the price levels of the two countries. The principal

defects of the purchasing power parity concept are that (1) many goods and services are not in competition internationally, either because they are not made in both countries or because their movement is impeded by transportation costs or government restrictions; (2) foreign exchange is demanded not only for merchandise imports but also to make investments abroad and to speculate. Despite these caveats, there is more than a grain of truth in the proposition that exchange rates among inconvertible paper currencies must have some rough relation to their relative internal purchasing power.

#### **TRIANGULAR CURRENCY ARBITRAGE**

The exchange rates of different national currencies must be compatible with one another, in the absence of exchange-control restrictions, if equilibrium is to prevail. There is a dollar price on the Swiss franc, for example; another dollar price on the Swedish krona; and an exchange rate between the Swiss franc and the krona. These three rates are compatible if (ignoring service charges) one money can be exchanged for another, and then another, and can finally buy the original quantity of the initial currency. This compatibility is brought about through arbitrage transactions.

Let us suppose a disequilibrium situation arises. The Swiss franc, say, is selling for \$0.22, the Swedish krona for 0.75 Swiss francs, and the dollar for only 4.8 kronor. Ignoring all commission expense in this case, a dealer in foreign exchange could buy Swiss francs with dollars, buy kronor with the francs, buy dollars with kronor, and end up with more dollars than he started with. Actual computations show that \$1,000 buys 4,545 Swiss francs at \$0.22 each. These 4,545 francs buy 6,060 kronor at 0.75 francs each. And 6,060 kronor buy \$1,262.50 at 4.8 kronor each. The completion of these three transactions results in a profit of \$262.50 on \$1,000.

Dealers in foreign exchange are on the lookout for just such short-lived profit opportunities and will make the three purchases

indicated above almost simultaneously. These very actions lessen the profit margin, however. The increased dollar demand for Swiss francs increases their dollar price to perhaps \$0.25; the increased franc demand for kronor increases the latter's franc price to perhaps 0.8 francs; and the increased kronor demand for dollars increases their krona price to perhaps five kronor. The final result may be that \$1.00 buys 4 Swiss francs, a franc buys 1.25 krona, and a krona buys \$0.20. These three exchange rates will be compatible because \$1,000 will now buy 4,000 Swiss francs, which will buy 5,000 Swedish kronor, which will in turn buy exactly \$1,000 again. The test of exchange-rate compatibility, ignoring expense, is whether the product of the various prices is unity.

The possibility of making a profit from arbitrage transactions sets up a circular flow of funds from currency to currency. The direction of this flow is always away from the premium money toward the discounted money. The flow continues until the rates are once more compatible. This inspired flow of funds circulates in a direction opposite to that of any abnormal net movements in funds transferred for ordinary business reasons. For example, if the Swiss franc is selling at a discount only in terms of the dollar, this may be because the United States has an unusually large export balance with the Swiss and is collecting payment, in which case arbitrage operations, as already described, create a countervailing movement of funds from dollars into francs, and then back to dollars via some third currency.

However, it should not be imagined that arbitrage strengthens one money versus all other monies: arbitrage creates an abnormally large demand *and* supply of a currency at the same time. In the example already given, there was a large and novel dollar demand for Swiss francs, but there was also a large and novel krona supply offered for dollars. Accordingly, the dollar depreciated in terms of francs and appreciated in terms of kronor, and probably retained its customary valuation in all the many remaining currencies. If a nation's money is weakening, it will sell at a discount in *all* currencies, and arbitrage will merely ensure that this depreciation is proportionate in terms of all currencies.

**FORWARD EXCHANGE**

In addition to "spot" foreign exchange markets, such as those described above, there are "forward" exchange markets in which, at prices agreed upon today, sellers contract to deliver foreign exchange at a specified future date. These forward markets perform several functions in addition to that of exchanging currencies. They permit an avoidance of risk through hedging, a lessening of exchange rate fluctuations over time through speculation, and a mitigation of differences in short-term interest rates among national money markets.

*Hedging.* Many firms engaged in international trade and finance wish to avoid the additional risks occasioned by unpredictable fluctuations in exchange rates. Thus, if a United States importer is about to commit himself to a payment in francs in 90 days, he should seek to buy future franc exchange now, at a known dollar price, for delivery in 90 days. In this way he avoids the necessity of being an unwitting speculator in franc exchange as an incident of his ordinary business as an importer.

*Speculating.* On the other hand, there are some people who attempt to earn a livelihood by speculating in forward foreign exchange. Thus, if a speculator believes that the dollar price of French francs is likely to be less in 90 days, he will offer to sell francs for future delivery, at a price, other things equal, slightly below that prevailing in the "spot" market. If he is right in his prediction he will make a profit by taking this "open" position—but he will lose if he is wrong. His fate, though, is of less concern to us than the consequence of his actions. To find a buyer—perhaps the importer just mentioned—he will have to shade his price and thereby divert someone who wants franc exchange away from the "spot" market. This will very slightly depress the current dollar price of francs and so the expected softening of the franc is felt to a limited extent at once.

*Arbitraging Interest Rates.* Exchange dealers buy and sell foreign exchange as do speculators, but unlike speculators they strive

to cover their risks. Thus, if an exchange dealer sells francs for future delivery to an importer, the exchange dealer may buy francs in the "spot" market. If so, he gives up a dollar bank balance for a franc balance for 90 days or so. If short-term interest rates are higher in Paris than New York he gains a little interest income if the dollar price for francs is no higher in the spot market than in the forward market. In practice, though, competition among exchange dealers is likely under these circumstances to put "spot" francs at a premium relative to "forward" francs. In this way effective short-term interest rates tend to be equalized among financial centers.

### SEMIGOLD CURRENCIES

At various times different nations may be half on and half off a real gold standard. The central banks of many national governments stand ready to buy gold at a relatively fixed price when quoted in their own local currency, but they will not sell gold for their own currency. Governments may also dabble in the gold market, both as buyer and occasional seller, but at a variable price, in uncertain amounts, and on their own initiative. These operations establish a partial link between the national currency and gold.

For example, let us suppose that the Bank of France will *buy* all gold which is offered to it at 14,000 francs a fine ounce, and that the United States Treasury stands ready to sell gold on demand at \$35 a fine ounce. The French franc cannot then appreciate above \$0.0025 and the dollar cannot depreciate below 400 francs. Or, if this did occur temporarily, arbitrage transactions involving gold would soon bring the rate back into line. As an illustration of this, if the franc appreciated to the point where it was worth \$0.0030 people would sell francs for dollars, would then sell dollars to the United States Treasury for gold, and would then sell the gold to the Bank of France for more francs than they had at the outset. The effect of these operations would be to increase the supply of francs in the New York market and increase



the demand for dollars in the Paris market so that the franc would begin to depreciate relative to the dollar.

The general rule is that when one central bank is buying gold and another central bank is selling gold, both at stable prices on demand, the relative valuation of the two currencies they issue is linked on *one* side. The value of the money of the central bank selling the gold cannot fall below a certain level. And the value of the money issued by the central bank buying gold cannot rise above a certain level.

### GOLD STANDARD CURRENCIES

Before 1914, and again for a brief interval of several years between 1924 and the great depression of the early 'thirties, most of the leading commercial nations of the world were on a gold standard. They were on a gold standard in the sense that their central banks stood ready to buy and sell gold on demand, in unlimited quantities, and at a fixed local currency price; moreover, international shipments of gold and personal possession of gold were unrestricted. Although those days of an international gold standard may never return, the way in which it used to function is not without interest; for instance, many gold standard principles would apply to an international system in which currencies were freely convertible, not into gold, but into dollars.

Before and after World War I, the United States, the United Kingdom, and many other nations were on an unqualified gold standard, as defined above. The gold sovereign contained 113.0016 grains and the gold dollar consisted of 23.2200 grains of pure gold. The reciprocal of the gold-content ratios is the *mint parity*. Hence, the exchange rate of dollars to pounds, based on the mint parity, was as 113.0016 is to 23.2200. This quotient gives a price of \$4.8665 for one pound sterling.

If both countries were on a gold standard, a person who wished to transfer a large sum from dollars into pounds could do this in two ways. He could either buy sterling exchange with dollars in the ordinary way or ship gold from the United States to Great

Britain. If the second method entailed no special expenses, he would get an effective exchange rate of \$4.8665 to one pound sterling.

However, there always is some expense attached to gold shipment. The gold has to be crated; there are freight, insurance, and safeguarding charges; a small amount of interest earnings are lost while the gold is in transit; there is a little loss from abrasion; and the central bank of the receiving country may charge a fee for a minting service no longer actually performed. These various costs amounted to about two cents per pound sterling before the war.

In practice the exchange rate between the dollar and the pound used to fluctuate over a range of two cents on either side of the mint par. There were no gold shipments as long as the rate remained within this narrow range set by the *gold export point* and *gold import point*. If a debit flow developed in payments of the United States to Great Britain so that a strong dollar demand for pounds set in, the rate would rise to \$4.8865, at which point gold would be exported from the United States in lieu of a direct purchase of pounds with dollars.

Under a gold standard anything which decreases the cost of gold shipment narrows the limits within which the exchange rate may fluctuate. This *spread* would be practically eliminated if gold could be bought from one central bank and sold to another without any physical transfer taking place, a possibility that was realized to some extent during the period between World War I and World War II. Some central banks were then willing to hold a portion of their gold reserves in the form of earmarked bullion in the vaults of other central banks.

### GOVERNMENT INTERVENTION AND EXCHANGE RATES

National governments have always had a hand in determining the foreign valuation of their domestic currencies. In the days of the gold standard, as we have seen, the price in local currency at which a central bank bought and sold gold served to determine the international value of its currency; if it raised its buying and

selling price of gold, it was said to have decreased the gold content of its money, and *vice versa*, despite the fact that gold coinage ceased to circulate in most countries after 1914. When central banks issue inconvertible paper currency, as is the general case today, national governments can influence the foreign value of their domestic monies in two possible ways. They may operate so-called stabilization funds. But, more frequently and more important, they may exercise exchange control. In the latter event, especially when foreign owners of domestic balances are not free to transfer them, the modern phenomenon of disorderly cross rates will almost inevitably develop.

#### HOW STABILIZATION FUNDS OPERATE

The middle thirties witnessed the establishment of a number of national stabilization funds. The forerunner of these was the British Exchange Equalization Account, established in early 1932. The United States established a fund of its own in 1934. France, Switzerland, and the Netherlands also created such funds, and either the treasuries or central banks of all the major powers were attempting stabilization activities by the time war broke out in 1939. The ostensible object of these funds was to iron out seasonal and short-term fluctuations in exchange rates; however, in a number of cases, stabilization funds were also used to maintain the trade advantages of relative undervaluation. How did these funds operate?

A national stabilization fund operates by selling its own country's money (if this appears to be appreciating excessively in value) and by purchasing it with foreign currencies (if it appears to be depreciating unduly). A stabilization fund does not employ compulsion, but acts as a foreign exchange trader, shifting from one side of the market to the other as the situation seems to dictate. However, there is one important element of asymmetry in the operation of a national stabilization fund. When it is seeking to prevent appreciation, a fund dumps its home or local currency on the foreign exchange markets; and, in case of an emergency, it

can always resort to the central bank or national treasury for additional local currency. But when local currency is depreciating on the foreign exchange markets, a stabilization fund can only support its national currency by purchasing it, which specifically means selling gold and foreign exchange for local currency. Now a national stabilization fund naturally has only a limited stock of gold and foreign exchange to sell in support of local currency. Hence a government stabilization fund can operate more effectively and continuously to depreciate its own currency than to appreciate it.

The composition of a stabilization fund's assets is always changing. When supporting the local currency, its assets come to comprise less gold and foreign exchange and more local currency. When depressing the local currency, it is substituting foreign exchange or gold for local currency among its assets.

During World War II, many Latin American countries were hard hit by the loss of their main markets in Europe, and by the lack of shipping space to carry their exports. The United States—in line with its Good Neighbor Policy—had its Stabilization Fund make loans to Mexico, Brazil, and a number of other countries below the border. These bilateral agreements contained three major provisions. The Fund was to (1) buy these national currencies up to prescribed limits, as they required support, then (2) hold them off the market, until (3) the foreign governments chose to repurchase their money at the same price. In several instances the purchased currency was backed by collateral (strategic mineral stockpiles, for example), but in others it was not.

Such an arrangement illustrates an important theoretical point. When the United States supplies a foreign economy with dollars and holds its currency without additional collateral as security, there is a transfer of purchasing power. The foreign economy can now buy in the American market, or in any other country where people will sell goods for dollars, whereas the United States economy holds, rather than uses, the pledged foreign currency. Genuine support of a foreign currency constitutes a transfer of purchasing power. When a foreign money is bought because it is weak, and held until it is strong, the holding country is essentially

making an indefinite loan, rather than an exchange, because the holding country does not use the money it has purchased.

#### EXCHANGE-CONTROL PRINCIPLES

Historically, exchange control has been an outgrowth of exchange stabilization funds in many countries, but the practical differences between them are so great that they really constitute distinct types of intervention. A stabilization fund operates as a trader, and utilizes the international currency markets, whereas an exchange control may make itself the only legal market. A stabilization fund does not interfere with anyone's freedom to buy or sell foreign exchange at the stabilized price, whereas an exchange control prohibits certain persons from holding or acquiring foreign exchange without permission.

In those countries where there is effective exchange control, residents are required to sell all foreign exchange that comes into their possession (whether from exports or from any other source) to the exchange control at a local currency price set by the control. Moreover, in these countries a resident can purchase foreign exchange, usually at prices in local currency set by the exchange control, only for those purposes and in those amounts which the control approves. Local currency may not be smuggled out of the country. In effect the exchange control places itself between the local residents and all foreign monies. The control becomes, as it were, a monopolistic seller of foreign exchange to local residents and a monopsonistic buyer of foreign exchange to which all local residents must immediately sell. Exchange control schemes depend upon compulsion whereas stabilization funds do not.

An exchange control, being both a monopolist and a monopsonist, can discriminate to its heart's content. It can buy foreign exchange at one set of low rates, and sell it at another set of high rates, in which case it will make a profit in terms of local currency. It can charge one price on foreign exchange needed for commodity imports and another price on foreign exchange needed to make foreign loans. It can have one price on imports of butter and an-

other on exports of lard. It can have one price on automobiles from the United States and another on motor cars from Great Britain. It can buy and sell at dozens of different prices.

#### DISORDERLY CROSS RATES

The almost universal existence of exchange control has put an end to arbitrage operations of the kind already described. Exchange controls do not permit purchase of foreign exchange for such purposes. As a consequence, many prevailing exchange rates are inconsistent with one another and these inconsistent exchange rates are sometimes referred to as disorderly cross rates.

What are disorderly cross rates? Perhaps the simplest way to explain is to give an example. Let us suppose that the price of a pound sterling is 280¢ and the price of a French franc is .25¢, both quoted in New York. Now 280¢ divided by .25¢ is 1,120; the franc price of sterling in Paris, which in this case is a cross rate, should be 1,120 francs. If it is not but is instead, say, 1,000 francs, there is a disorderly cross rate.

How do disorderly cross rates arise? Most systems of exchange control embody limitations upon convertibility. The foreign exchange proceeds which exporters earn cannot normally be sold by them to importers of a third country. For example, when British exporters to the United States earn dollars, they are not free to sell these dollars to French importers who wish to buy American goods. Limitations of this kind eliminate any reasons for supposing that the dollar price of one pound sterling, times the sterling price of one franc, times the franc price of one dollar will yield a product of one. Such inconsistencies as exist among these exchange rates are due to the fact that the demand of the United States for British and French goods may not be in the same relative strength as the British and French demands for American goods.

Actually, exchange controls usually set an official rate of exchange, and then ration foreign exchange at this price as it becomes available from exports and other sources. In order that foreign exchange will not be bid up in excess of the official rate the

control will grant only limited permission to buy foreign exchange to relatively few applicants. Such a policy might be described as one of exchange rate stability with restricted foreign exchange purchase.

### PROBLEMS

1. "Unrestricted arbitrage among three currencies will prevent disorderly cross rates but will not strengthen or weaken any one currency." *Explain.*

2. "Professional speculators in the 'spot' and forward exchange markets serve no useful function and should not be permitted." *Evaluate.*

3. "A government stabilization fund acts as a trader but an exchange control acts like a policeman." *Explain.*

4. "A stabilization fund has an almost unlimited capability of depreciating or appreciating the national currency in foreign exchange markets." *Evaluate.*

5. "The world even today is for all practical purposes on a full gold standard with every government prepared to buy gold and some governments—such as the United States—prepared to sell gold to foreign central banks." *Evaluate.*

6. "No one ever knows the value of a currency until it is tested in a free market." *Evaluate.*

7. "The gold standard is not a standard in which there is no control; on the contrary, it involves fixing the price of foreign currencies, controlling that price rigorously and trimming all other policies so that they square with the fixed exchange rate." *Explain.*

8. "Transfers of short-term money to London tend to widen the discount on forward sterling, which in turn encourages forward buying of sterling by importers in other countries." *Explain.*





## CHAPTER 10

# Controls to Conserve Foreign Exchange

We now discuss the main ways in which governments intervene in exchange markets to conserve foreign exchange. Many nations have, or think they have, limited foreign exchange reserves. Most of such countries are not prepared to apply deflationary measures so as to equate the demand for, and supply of, foreign exchange at the prevailing exchange rate. Nor are they prepared to allow the exchange rate to seek its own level in terms of other currencies, thus equating the demand and supply at such a market exchange rate.

Instead, such countries use one or both of two general types of measures to conserve foreign exchange:

1. They ration the supply of foreign currencies.
2. They circumvent the international payments machinery by using agreements with other countries under which transactions are financed without using international currencies.

### EXCHANGE CONTROL

An exchange control or exchange restriction is any interference by government with the freedom of the market in which one currency may be exchanged for another. The emphasis here is upon interferences with transactions involving the exchange of one cur-

rency for another. Such restrictions include interferences with persons owning home or foreign currencies whether or not the transaction takes place at home or abroad. For instance, the British Treasury may not permit sterling owned by a Belgian to be transferred to a man in Cleveland, even though the attempt to sell the sterling may take place in New York.

All of the countries except the United States and a handful of nations mainly in the western hemisphere have made wide use of systems of exchange restrictions.

#### **EXCHANGE CONTROL AND IMPORT LICENSING**

Exchange controls form a part of the whole complex of governmental regulations affecting the international economy. Restrictions with respect to exchange thus may be combined with other regulations to achieve a given end. For present purposes, this means that it may be difficult in some cases to determine whether an objective is being realized by way of exchange control or some other device. Import licensing in particular needs to be distinguished from exchange control.

Most countries that impose exchange control also use a system of licensing imports. The question thus arises whether a trader is unable to import a product because he has failed to obtain an import license or because the government has denied his application to buy the foreign exchange needed to pay for the item. In the strict sense, exchange control restricts a person in making an international financial transaction. But import licensing may be an indirect way of doing the same thing. It is necessary, therefore, to pay attention to import licensing arrangements when trying to understand exchange controls proper.

#### **THE PURPOSES OF EXCHANGE CONTROL**

Exchange restrictions are imposed by governments for a variety of purposes. The basic reason, however, is to protect the balance of payments, that is, to limit the drain on foreign exchange

reserves which it is believed would occur at the prevailing exchange rate in the absence of controls. There are also secondary reasons. In some cases, for example, exchange restrictions are used to implement bilateral payments agreements. Switzerland and some countries in Latin America fall in this category. There are also cases in which countries use exchange control to handicap some foreign goods competing with domestic products.

Capital transactions come in for heavier control as a rule than do current transactions. This is because only the financially strongest nations believe they can face disturbed political and economic conditions at home without some control over flights of capital: such flights can greatly reduce their holdings of international reserves and also impair their domestic monetary structure.

### **COST VERSUS QUANTITATIVE RESTRICTIONS**

Thus far we have been speaking about the first of two general means of controlling the demand and supply of foreign exchange. That is, we have been speaking of quantitative limits or prohibitions on some transactions. We must now address ourselves to the second means. A government may control the amount of particular transactions by establishing two or more rates at which foreign currencies may be bought and sold. One rate may apply to transactions involving so-called "essential" imports; and another rate, requiring more units of home currency to buy a given quantity of foreign currency, may apply to luxuries. By this means essentials may be favored over luxuries.

The same system of differential exchange rates may be used to discourage or favor particular exports. Thus, by varying the home currency price at which foreign exchange may be sold to the banks of the exchange-control country, the nation may subsidize some exports that are deemed to require special encouragement. For example, if a nation has a comparative advantage in wheat, but not in duck feathers, it may permit sellers of duck feathers to sell, say, dollars at 5 units of home currency per dollar instead of the regular rate of 4 units. By such means local producers of duck feathers can

offset a 25 per cent production cost handicap as compared with competing producers in other countries.

Countries using differential exchange rates are said to employ multiple exchange rate systems. Such multiple rates are legal rates, and are to be contrasted with the normal (small) spread between buying and selling rates such as are found both in non-exchange control situations as well as in single-rate exchange control cases. About half of the countries that employ exchange control make use of multiple rate systems.

#### **THE CONTROL OF PAYMENTS**

The authorities base most of their decisions on answers to this question: What is the purpose of the intended foreign payment? In many countries, this purpose is indicated by possession of a valid import license. That is, the import licensing authorities have seen to it that only those desiring to import essential items are granted licenses; and the exchange control people will honor such licenses by granting the appropriate foreign exchange.

It is common to find import licensing on the following bases: (a) some imports are generally licensed from all countries without limit; (b) other imports, possibly including commodities under (a), are generally licensed without limit from specified soft-currency countries, that is, countries the currency of which is abundantly supplied in the exchange-control country; (c) still other imports that require individual licenses which are freely granted up to stipulated quotas either from all foreign countries or a group of such countries; and (d) a residuum of imports that are licensed only on a case-by-case basis.

What is the relative importance of the products in categories (a) through (d)? We find that for most countries the list under (a) will be short, representing goods that are scarce worldwide. Category (b) may be wide, since payment may be made in currencies that are readily available. The list under (c) is likely to be narrow, representing goods that are available only from hard-currency countries (such as the United States) or available on the

best price terms from such countries. All other imports are handled under (d).

How is control over payments assured by the authorities? The answer is that governments see to it that the appropriate type of payment is made by having importers make payments only through an authorized bank. Such payments may be in the home currency or in a foreign money. We may illustrate the former case under British conditions. Thus, an Englishman must make payment to a nonresident's sterling account, which an authorized British bank will handle on a basis separate and distinct from that of accounts held for the ordinary Briton. We may also illustrate the use by a Briton of foreign currency that he may hold. Thus, a British resident, who is allowed to hold Dutch guilders, must transfer his guilders to a Dutch exporter in making payment for Dutch goods through an authorized bank. Two purposes are served by this kind of requirement. First, it provides a check on the use of foreign exchange, to show whether the use is in accordance with regulations. Second, it yields a statistical record on earnings and disbursements of foreign exchange. The second purpose, we may add, is important especially in determining a country's bilateral payments position with another country.

#### **THE CONTROL OF RECEIPTS**

Control over supply is essential to the administration of exchange control, if only to assure smooth operations of exchange allocation machinery. Hence, as has already been indicated, the authorities usually require exporters and others receiving foreign exchange to surrender their proceeds to an authorized bank in return for home currency.

Two methods of enforcing surrender are generally employed. First, export licensing may prevail, under which the exporter must fill forms and agree to turn over his proceeds within a specified time to an authorized bank before his export license is validated. Goods are not allowed to pass through customs without such a

validated license. Second, where export licensing is not used the authorities require exporters to obtain a "sworn declaration" from an authorized bank before the goods will be passed through customs. This declaration contains a commitment to surrender the proceeds.

#### CONTROLLING CAPITAL MOVEMENTS

Nearly all exchange control systems regulate the inflow as well as the outflow of capital funds. The control over capital outflows is not hard to understand. Countries that are concerned about a loss of foreign exchange reserves are reluctant to see a drain occur through capital exports. There is one exception: investment that is likely to earn considerable foreign exchange.

In this connection, it needs to be emphasized that the controls over payments for imported goods and services and the surrender of export proceeds are an integral part of the control of capital exports. More specifically, we should say they are an integral part of the control of unauthorized capital exports. Thus, an Englishman who overstates the amount of the bill for imports, or under-invoices exports, obtains foreign exchange that he can leave abroad—that is, he exports capital. Most controls succeed in preventing the grosser forms of overbilling of imports and underbilling of exports, but there probably never has been a control system, the British included, that has completely succeeded in stopping illegal capital movements.

Why do countries control inward movements of capital? One would think that countries with less than adequate exchange reserves would welcome capital inflows. Well, they do. But there is more to the matter than that. In some cases, the control country may want to avoid the inflationary effects of capital inflows. Switzerland, for example, imposed controls for this reason after the last war. In other cases, countries may use the control of capital inflows as a means of checking the remittance of earnings on unproductive or undesirable investments made by foreigners. Gov-

ernments following very nationalistic policies commonly control capital inflows for this reason. In still other cases, control is used to obtain statistical information that might otherwise be difficult to secure.

### TRADE AND PAYMENTS AGREEMENTS

When one moves outside North America and the northern part of Latin America (the so-called "dollar area"), he finds that most of the trade takes place in accordance with intergovernmental agreements. These accords cover the method of payment, or the goods and services which may be traded, or both. We must say something about such agreements because they are so closely related to the payments system proper. Though the agreements may be bilateral as well as multinational, we shall now concentrate on the former.

#### THE BILATERAL TRADE-QUOTA ACCORD

An important device is the bilateral trade-quota agreement. The two countries agree upon two lists of products, each showing quantities and values, against which they agree to grant import and export licenses. Country A agrees to grant licenses to import from B, and Country B agrees to do the same regarding goods from A. Trade need not take place exactly as set forth, since the agreement is to issue licenses up to the amount of the quotas. It is chiefly by means of such agreements that many countries have sought to balance their current accounts bilaterally. In some cases, however, the agreements have been used in an effort to expand two-way trade; and in still others, the aim has been to bargain certain scarce goods against other scarce goods.

The evidence clearly shows that the net effect of such bilateral deals is to lower the level of total trade and to reduce the economic advantages from trade, as compared with the situation under unrestricted trade.

**BILATERAL PAYMENTS AGREEMENTS: THEIR NATURE**

The means by which current trade is financed between two countries under agreements here being discussed are set forth in a bilateral payments agreement. Though these agreements take many forms and differ a great deal in detail, they contain the following elements as a rule: (a) A statement that outlines a *general* method of financing trade between the two countries (or currency areas) as opposed to means of financing trade in specific products; (b) agreement as to a unit of account; (c) provisions which assure that each transaction results in a credit or debit, or both, in the accounts of the two countries (this is to make sure that the agreement is all-inclusive as far as trade between the parties is concerned); and (d) provisions which limit the use of credits under the agreement to pay for goods and services from other countries.

Let us outline a key feature of a bilateral payments agreement. It consists of an arrangement by which each country agrees to sell the other its own currency up to a stated limit. Importers then make payment, in accordance with exchange control regulations, by obtaining from their own banks drafts on the other country's banks. It is expected that the total of a country's drafts on the other country will be offset by a similar total of the other country's drafts on it. To illustrate, Country A agrees to sell Country B its own currency up to, say, 50 million currency units per year; and Country B agrees to sell its own currency to Country A up to an equivalent amount. Importers in Country A then obtain drafts on banks in Country B from their own (that is, Country A) banks. Similarly, importers in Country B go to their own banks to obtain drafts on banks in Country A. Both countries expect to have claims on each other of just 50 million currency units in each period—that is, they expect their transactions to balance bilaterally. Failing balance in each period, they hope that a temporary imbalance in favor of one party in one year (say, because of the failure of the other party to export enough to it) will be offset by an imbalance



in favor of the other party in the succeeding year. As will be indicated presently, specific machinery exists to deal with such imbalances.

#### **OPERATIONAL AND OTHER CHARACTERISTICS**

Features in the foregoing will be clarified if we discuss some of the specifics in greater detail.

First, the agreements must deal with the unit or currency of account. Since two currencies are involved, a fixed rate of exchange between them must be agreed upon. In the absence of agreement on such a rate, there would be day-to-day fluctuations in the exchange rate and hence the respective central banks would be exposed to losses. That is, if the exchange rate fluctuated Country A's holdings of B currency would fluctuate in value; the same may be said for Country B's holdings of A currency. Usually, one of the partner's currency is not used to finance international trade, and so the practice is then to use the currency of the other country as the unit of account if that currency is in general use to finance trade. Where neither country's currency is used widely in financing trade, it is common to find the parties agreeing on the use of the dollar as the unit of account. The dollar is not used in payment; it is merely the unit in terms of which each of the countries keeps its accounts under the bilateral payments agreement.

Second, the agreements must deal with arrangements for billing exports and drawing drafts. As a rule, these actions conform to normal trade practice. Balances earned are allowed to be transferred between residents without restriction. The exchange control authorities probably will require exporters to surrender the currency of the partner country; but if they do not, each country's central bank must be ready to buy the partner's currency from its own residents.

It has previously been stated that a key feature of the agreements is an arrangement under which each country agrees to sell

the other its own currency up to a stated amount. To implement this at the trading level, it is necessary for each country's central bank to supply ordinary banks with the currency of the other country in an amount sufficient to meet authorized payments. Ordinary banks and traders, however, will hold only rather small working balances in the other currency. Hence, each country's foreign currency balances will be held mostly by the central bank. Changes in the bilateral trading position of the pair of nations thus will be reflected in each central bank's holdings of the partner currency.

Third, bilateral payments agreements must contain provisions for the mutual extension of credit beyond the agreed limit if there is to be reasonably smooth mechanical operation of the agreements. For example, some transactions may take place late in the agreement year. These may have to be restricted in size if the country in question is to stay within the agreed limit. In such cases it would be better to allow a debit position to arise, and to adjust during the course of the next agreement period. To cover such situations, there is an assured margin in the current account balance, beyond the agreed credit limit, that need not be covered by gold or convertible currency. This margin is usually referred to as a "swing credit," by which is meant reciprocal credits which permit trade between the partners to be unbalanced in either direction up to a specified amount beyond the agreed limits without settlement during the life of the accord. Thus, if the agreed limits are 50 million currency units for each party, the swing credit may be of the order of 5 million units. In effect, the swing credit enlarges the scope of the agreement.

Even so, credit balances may accumulate. If they are large, they usually are settled by a long- or intermediate term loan from the creditor partner. Sometimes, though, the credit balance is settled by the export of commodities by the debtor country.

Fourth, bilateral payments agreements contain provisions for settlement of credits that may be outstanding at the termination

of the agreement. Typically, the relevant language calls for settlement in gold. But most agreements are not terminated after an agreed date. Rather, they are renewed or revised from time to time. On such occasions, the parties usually convert whatever balance is left into a long- or immediate-term loan (that is, they fund the balance).

Fifth, the payments agreements usually spell out the transactions that are permitted under the agreement. In some cases, all current transactions are to be financed under the agreement; but in others specified items of trade are excluded. For example, countries having exports that are readily salable for dollars may not permit the exports in question to be payable with inconvertible currencies of the agreement countries. Such exports must be financed with dollars outside the payments agreement. Private capital movements are also excluded, as a rule, except for interest and amortization payments connected with debt.

Sixth, payments agreements commonly contain provisions designed to prevent the emergence of excessive debit or credit positions. In many cases, the agreement calls for an exchange of notes between the pair of countries, each government then agreeing to encourage trade in specified goods—imports by the creditor and exports by the debtor. Both parties usually appreciate that a successful payments agreement requires the avoidance of persistent bilateral deficits in current trade. (As far as western Europe is concerned, this attitude has changed as a result of the operation of the European Payments Union, discussed later.)

Finally, there usually are provisions dealing with the transferability of balances. To what extent may balances or credits be transferred to third countries? Most countries that sign bilateral payments agreements refuse to permit such transferability. Britain, however, has sought to increase the transferability of sterling, and the agreements signed by her generally permit the transfer of sterling between nonsterling countries either on an automatic basis or by special permission of the British authorities. (The reasons for the British attitude will be set forth below when we discuss the sterling area system.)

### EXCHANGE CONTROL ILLUSTRATED: HIGHLIGHTS OF THE STERLING SYSTEM

The case of British exchange control is of some interest because sterling shares with the dollar the role of financing most of the world's trade. Since most members of the sterling area (mainly the British Commonwealth, excluding Canada) pattern their own controls largely after Britain's, for the purpose of maintaining the solvency of the area as a whole, our discussion will be of pretty broad scope.

Britain's own exchange control is based on the Exchange Control Act of 1947. All banks in Britain must carefully comply with regulations regarding the transfer of funds on their books. There is special machinery whereby all payments made by Britons to foreigners and by one foreigner to another are channeled through special bank accounts. Funds in the various bank accounts can be used only in the way specially prescribed for the individual account. We shall see that the use one can make of balances in British banks depends mainly on the country of *residence* of the holder of the balance.

There are three major classes of sterling accounts. The sterling balances owned by residents in any one country are designated by the account name of the class in which the resident's country is found. Thus, a sterling area account name on the books of a British bank is a "resident account." A Chicago account name on the books of, say, Lloyds Bank in London is an "American account." The account name of a Frenchman is a "transferable account." You may find the account applicable to persons in the principal countries by inspecting the following three classes of sterling accounts.

1. *Resident Accounts.* These are the accounts of persons living in Britain, the Commonwealth except Canada, British colonial and mandated territories, Iraq, Kuwait, and one or two other countries. These countries make up the "sterling area." All sterling held in the names

of residents of these countries is called "resident sterling" and the accounts are "resident accounts."

2. *American Accounts.* The residents of the following principal countries own American accounts: Canada, the United States, the Republic of the Philippines, and most of the northern countries in Latin America.

3. *Transferable Accounts.* These accounts are established for residents of all other countries.

Transfers from one resident account to another resident account may be made without restrictions and without complying with any controls. Thus, a Briton could send his personal check to a relative in New Zealand just as checks are sent between San Francisco and Chicago. But the same Briton could not send a check drawn on Lloyds Bank to a man in New York, since the British bank is not permitted to transfer sterling from a resident account to a nonresident account, except with the permission of the exchange control authorities.

American account sterling, which arises mainly from exports from the dollar area, may be used to buy any kind of sterling, or transferred into dollars. But other sterling cannot be transferred to an American account, except with specific approval. Such approval is given as a rule only to pay for authorized imports into the sterling area from the dollar area. One of the reasons for allowing this freedom of use of American account sterling is to induce those who have claims to dollars, a scarce currency, to hold sterling on the understanding that they can transfer out of such sterling into dollars at will. In the absence of such terms, the people in question would be reluctant to hold sterling.

Transferable sterling is that which is held by residents of all other countries than those already covered. The distinguishing characteristic of such sterling is that it is freely transferable on the books of British banks from the name of any person in one transferable account country to the name of any person in any other transferable account country. Much of the world's trade is financed in terms of transferable sterling.

American account sterling has a price in terms of dollars that is maintained by the Bank of England within a narrow range of

the dollar-sterling parity, that is, \$2.80. Transferable sterling, however, fluctuates over a wider range in line with changes in the forces of supply and demand, but the Bank of England from time to time enters the market to moderate fluctuations. In recent years, transferable sterling has been held within 1-2 per cent of parity. Since it, like American account sterling, is sold in New York, holders of transferable sterling can in effect command dollars at a small discount by selling holdings in the New York market.

### PROBLEMS

1. "A nation may overvalue its currency and conceal this state of affairs for a time by employing exchange control." *Explain.*

2. "Exchange control is a sure way to gain all the advantages of the international division of labor without suffering adverse financial consequences." *Evaluate.*

3. "The existence of an exchange control system is not necessarily a guarantee against the illegal export of capital." *Explain.*

4. "Bilateral payments agreements, like the proverbial chain, are no stronger than the weakest partner link." *Explain.*

5. "The world would probably see far fewer bilateral payments agreements if more countries pursued conservative domestic monetary and fiscal policies." *Evaluate.*

6. "If I were in a position of authority," writes an observer, "I would stop exports to the other country whenever that country exceeded its agreed limit under our bilateral payments agreement." *Evaluate.*

7. "The ability of nonsterling area countries to dispose of transferable sterling in New York means that the sterling area has no control over drafts on its gold and dollar resources." *Evaluate.*

8. "If a small discount on transferable sterling may be overlooked, all nonresident sterling is convertible." *Explain.*

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## **Mechanisms to Promote Stability and Freedom of the Exchanges**

Since the early 1930's, when traders over large parts of the free world first began to be shackled by all manner of exchange controls and bilateral payments devices, there has been a yearning for the twin ideals of reasonable exchange stability and sufficient freedom to transfer funds internationally. What measures have nations taken to attain or move in the direction of attaining such ideals? Which actions have been successful, or partially so, and which have not? What, if anything, does the relevant experience teach us? It is to these and related questions that we now turn.

### **THE STERLING AREA SYSTEM**

✓ The sterling area, which in some respects goes back a number of decades, may be said to have assumed modern proportions with Britain's abandonment of the gold standard in 1931. Exchange-rate stability now threatened Britain and a number of other countries having close trading and financial ties with London. Was the very wide use of sterling as a means of international payment about to come to an end? Would sterling be made subject to stringent exchange controls? Would countries which formerly held large



sterling balances in the form of (1) official exchange reserves and (2) working balances for financing current trade now shift to the holding of dollars? What about countries having sizable trade with Britain? Would they now find their export earnings fluctuating unpredictably as sterling, no longer anchored to gold, itself fluctuated in value in the foreign exchange markets? Finally, would United States commodity and financial markets prove to be both big enough and stable enough to be attractive as compared with those in Britain? ✓

—The sterling area system, a complex and demonstrably viable arrangement, has developed over the years largely in response to the pressures summarized or implicit in the foregoing list of questions. The system did not evolve on the basis of blueprints, as a three-bedroom house with its stable and known components may be said to evolve. Rather, the system evolved on the basis of (1) the negotiating skill for which the British are justly famous and (2) the marked community of interest that has prevailed among a number of countries, the key units of which were then and are today members of the British Commonwealth. —

Briefly, countries making up the sterling area (the country composition has changed somewhat over the years) saw the following line-up: the United States market of the thirties was not only unstable but actually markedly depressed. American foreign lending had almost dried up, as a result partly of the state of the domestic economy and the record of relatively poor overseas lending during the twenties; hence, the United States offered few attractions either as a market or as a source of capital; Britain's foreign exchange reserves were still formidable; the brains in London which for centuries had guided sterling and British foreign economic relations were probably no less equal to the new tasks under the admittedly unsettled conditions of the time; the British market was strong and, in relation to the depressed American economy, relatively buoyant; foreign lending, an important matter, was still going on from Britain; finally, it was realized in most of the countries that were traditionally close economically to Britain that means existed with which to keep their own exchange rates stable in

relation to sterling even if sterling should fluctuate in terms of such gold currencies as the dollar and the French franc. ✓

### **PREWAR ARRANGEMENTS**

The sterling area system operated before World War II in ways different from those prevailing since its end. Before the war the sterling area was a currency area above all else. Its distinguishing feature, still unchanged from tradition, was the fact that the pound sterling was both an international means of settlement and an international monetary reserve currency. Members of the sterling area used sterling to settle their common international transactions, and their central banks used sterling balances in London as the principal reserve backing for their respective national currencies and central bank liabilities. In fact, [one identified a sterling area country by two criteria: did it maintain its currency in a fixed exchange-rate relationship with the pound sterling? And did it keep most or all of its exchange and monetary reserves in the form of sterling bank balances and other liquid assets in London? ]

[There were five main reasons for the tie-up with sterling prior to the last war. Most of them are as important today as they were then. First, the bonds that tied the members of the British Commonwealth of Nations politically also helped to draw them economically. Second, there was a close financial relationship between many nations and Britain. Most of the nations of the sterling area had large long-term debts payable in sterling, the burden of which they wished to stabilize in terms of their own currency. Third, important commercial ties existed. Britain was a large market for their exports; in addition, preferential arrangements between Commonwealth countries and bilateral trade agreements with other nations strengthened these ties. Many of the nations sold over half of their exports to Britain. By linking their currencies to sterling, they protected the prices of their exports and safeguarded their competitive position in the British market by allowing their currency to depreciate or appreciate in line with sterling. Fourth, after 1929 national income and business activity had fallen much less in Britain than

in other leading industrial nations. Between 1929 and 1932, British industrial activity fell 17 per cent, whereas it declined 47 per cent in the United States. Finally, Britain was not only the world's largest importer before World War II, but she had the further advantage of being a relatively steady market for imports. Her imports consisted largely of human and animal foodstuffs instead of industrial raw materials, though the latter were and still are large. The United States, in contrast, imports mainly industrial raw materials; so that when industrial activity declines by a given amount in the two countries, our imports fall to a much greater extent than do Britain's.]

How did sterling area arrangements before World War II affect the rest of the international economy? As we have seen, these arrangements were essentially exchange-rate arrangements. Their effects on the world economy were neutral, unless it is argued that they had the effect of producing greater stability than would otherwise have prevailed in international trade. Specifically, up to World War II the pound sterling was a fully and freely convertible currency. Members of the sterling area and their nationals wishing to transfer any part of their sterling balances to, let us say, New York, were free to do so. Although the sterling funds of members were, by mutual agreement, invested and administered for them by the Bank of England, a citizen of a sterling area country was free to go to his local bank and arrange to make any payment he wished in England, in other parts of the sterling area, or outside the sterling area countries.

#### **THE WARTIME SYSTEM**

At the outset of World War II Britain and the countries that remained in the sterling area (some dropped out) introduced one new feature: a tight exchange control. This innovation produced a fundamental change in the sterling area system. The change, introduced to enable Britain and her Commonwealth to husband gold and foreign-exchange resources for war purposes, served as a defensive measure during the war. British needs for imports increased

because of hostilities, but export capacity was reduced, owing to the drain of manpower from industry, and the conversion of industry to war production on an all-out basis. In situations of this kind, some British citizens and many foreigners with sterling balances would have transferred their funds to other countries for safekeeping or permanent investment; British exchange control prevented such transfers, and by so doing conserved dollars and gold.

At first the British introduced a relatively mild system of exchange control. There was little control over the use of sterling held by nonresidents, and British exporters found it possible to transfer capital by the simple expedient of under-invoicing merchandise sent abroad. In unofficial markets abroad, foreigners having sterling balances could dispose of such balances to other nonresidents who had payments to make in sterling. Such sterling generally sold at a discount, and there developed what was called a free sterling rate of exchange. This dropped to as low as \$3.20 to the pound, from the rate of \$4.68 before World War II and the wartime official exchange rate of \$4.03. The free sterling could be used to pay for a limited range of British exports. A few months after the outbreak of war, however, the London authorities clamped down on free-exchange dealings by requiring all payments to be made in official sterling, at the exchange rate of \$4.03 to the dollar. Several other loopholes were eliminated at about the same time. The official rate, incidentally, remained unchanged until 1949, when it was reduced to \$2.80.

Sterling area exchange controls were perfected slowly, in the light of experience. The World War II sterling area retained the main elements of the prewar system, namely, the fixed exchange-rate relationship to sterling and the policy of holding official monetary reserves of member nations in London. In addition, each of the sterling area countries developed a centralized control of foreign-exchange dealings generally patterned after and co-ordinated with that of Britain. Moreover, all of the member countries agreed to pool their nonsterling exchange and gold resources in London. That is, all dollars earned and gold mined or acquired by, for example, Australia, in excess of the value of her rock-bottom needs from

the United States, were sold to the London authorities for sterling. Australia gave up claims to dollars (and newly mined gold), but increased her claims on Britain to a corresponding amount. England acquired title to more dollars and gold, but also increased her sterling liabilities to members of the sterling area. The pooled dollars and gold were employed under centralized direction in the prosecution of the war. This meant that London had greater financial resources with which to make war purchases outside the sterling area (principally in the United States, which was unwilling to accumulate sterling balances and which could not, because of the Neutrality Act, extend loans to Britain). It also meant that London would make available nonsterling exchange to members of the sterling area whose payment relations with nonsterling countries, even on the basis of imports trimmed to rock-bottom needs, resulted in a deficit.

¶The pooling of sterling area foreign exchange and gold resources in London was of considerable significance. First, it involved a transfer of more desirable dollars or gold to Britain in exchange for less desirable sterling. India, Australia, and other sterling area countries deprived themselves of all or most of the dollars and gold that they might have saved for postwar use, in order that Britain might have more of them than she otherwise would have. This was not regarded as sheer gratuity by the other sterling countries because (1) they had a growing financial stake in a solvent Britain, since the latter was an important export market to them and they were now her creditors; and (2) they were assured of the right to buy dollars with sterling for essential purchases whenever necessary. Second, the pooling of the area's foreign (nonsterling) exchange and gold meant that exchange transactions between members of the sterling area could be largely free from control. For instance, transfers between Australia and New Zealand could be effected about as easily as before the war. Such intra-sterling area transfers did not increase or decrease Britain's indebtedness, but only resulted in a reshuffling of the claims on that country. As long as each member of the sterling area followed approximately the same rules regarding the use of dollars and other nonsterling currencies, the sterling area

as a whole was in a position to control the drain of its nonsterling resources to the outside world. There was no need, therefore, to restrict intra-sterling area payments.

#### **THE POSTWAR STERLING ACCOUNTS**

Most of the mechanics by which Britain and other sterling area countries control the use of foreign exchange were designed during the war. Through processes of trial and error, these have evolved into the system of sterling accounts which were briefly described in the preceding chapter. To repeat, Britain has resident accounts, American accounts, and transferable sterling accounts. The first-mentioned are the accounts that belong to persons living in the sterling area; the second are those that are owned by people in the dollar area, that is, the United States, Canada, the Philippines, and most of the nations in northern Latin America; finally, transferable accounts are those owned by persons in all other countries.

#### **TRANSFERABILITY AND CONVERTIBILITY**

As has already been indicated, each category of sterling enjoys certain terms of transferability as between countries. Thus, a New Zealander is free to transfer sterling he owns in London to a person in Australia; this is a transfer from one resident account to another. Similarly, an American is free to transfer sterling that he owns to, say, a Canadian; this is a transfer from one American account to another American account. Finally, a Frenchman is free to transfer a balance he owns in a London bank to, say, a Brazilian; this is a transfer from one transferable sterling account to another transferable sterling account.

Transferability within any one category of accounts is important, of course, as is transferability between categories of sterling accounts. The above discussion has been in terms of transferability within a single category. This must now be supplemented by briefly mentioning inter-account transferability. Specifically, trans-

transferable sterling may be transferred to a resident account (but transfers may not be made from such accounts) and a transferable account balance may be created by a transfer from an American account. Neither resident nor transferable sterling may be transferred to an American account, however. Note that the permitted transferability is to a more restricted category by one important criterion: the ability to acquire dollars with sterling. The significance of this will emerge from the following discussion.

Today, nonresident sterling is a *convertible* currency. That is, individuals who have acquired nonresident sterling from current transactions are able to use it to buy dollars. American account sterling has always been convertible, at the regular legal exchange rate. Transferable sterling has also been convertible into dollars over the years, but at rates reflecting the supply and demand in unofficial markets (mainly New York and Zurich). For about a decade after the war, transferable sterling was quoted at a marked discount from the rate for American account sterling. Transferable sterling was then held to be an inconvertible currency, by virtue of (1) the marked discount that prevailed, and (2) the lack of official intervention in transferable sterling markets abroad by the Bank of England.

There has been a notable improvement in the position of transferable sterling in recent years. First, the British liberalized various arrangements affecting commodity and gold markets in Great Britain. This had the effect of increasing the range of uses to which transferable and other sterling could be put; that is, it served to increase the demand for sterling. Second, the British permitted individuals and firms to engage in arbitrage transactions involving European currencies. This too served to widen the uses open to holders of sterling. Third, the sterling area was brought within the scope of the European Payments Union, described below. Finally, the Bank of England announced that it would enter the market for transferable sterling from time to time in order to stabilize the market. The result has been that transferable sterling is now exchangeable for dollars in markets abroad at a discount of only 1

per cent or so. In effect, therefore, transferable sterling may be counted on to yield dollars on terms not much different from those that have prevailed for years with respect to American account sterling.

The upshot of our discussion is this: the sterling area mechanism in its contemporary form is an instrument for providing (1) reasonable exchange stability and (2) a large measure of freedom for the transfer of funds internationally. Real restrictions continue to be applied only against those who own resident sterling; but the countries in question are members of the sterling area and may use sterling, consistently with sterling area "rules," to buy dollars so that they may acquire essentials from the dollar area or make payments on dollar debts.

Yet the managers of the sterling area system are not satisfied with the existing situation. Their ultimate objective is convertibility for all sterling, resident as well as nonresident and that arising from old capital transactions as well as that from current transactions.

### **THE EUROPEAN PAYMENTS UNION**

The most effective institution created in the postwar period for dealing with exchange stability and freedom of transfer has been the European Payments Union. Like the sterling-area system, this too has evolved largely as the result of a process of trial and error. Unlike the sterling-area system, however, the United States has had a hand in the shaping of the EPU.

#### **ANTECEDENTS**

✓ For several years after World War II the western European nations were notorious for their systems of exchange control and bilateral payments agreements, as well as for their extensive use of quantitative restrictions on imports. There was a tremendous job of reconstruction to do after the devastations of war. At the time, the dominant thinking was that of relying heavily on government



controls in nearly every sector. Licensing arrangements, of the kind used in wartime, extended to nearly all phases of the foreign exchange market.

But the economies did not thrive under the controls. On the contrary, as time went on it became clearer and clearer that wartime medicine was unsuited to peacetime needs. The shackles had to be removed, and stagnation had to give way to economic progress. And time was not on the side of free institutions, for the totalitarian planners of the East were busy drawing the blueprints for the westward extension of what Churchill has termed the Iron Curtain.

It was in this context that Washington offered Europe what has since come to be known as the Marshall Plan, or the European Recovery Program. We wished to accelerate the process of reconstruction and recovery in Europe by means of a system of aid that would permit Europe (1) to obtain a volume of imports that would otherwise have been beyond the area's capacity to pay and (2) to adopt intra-European measures that would re-enforce an aid-based impetus to economic expansion and pave the way to self-sustained growth. After about half a decade of Marshall aid western Europe was not only again on its economic feet but was actually one of the economically most robust areas of the world.

Organizationally, the Marshall program was conducted through the Economic Cooperation Administration in Washington and the Organization for European Economic Cooperation (OEEC) in Paris. The former was the American aid agency, and the latter the multinational European agency that programmed every feature of the recovery effort insofar as international measures were concerned. Our own aid agency has undergone considerable change in composition, function, and name since European economic aid, as such, has come to a virtual end. But the OEEC, with its several specialized divisions and committees (dealing with trade, payments, transportation, productivity, agriculture, and the like), continues to deal with a variety of intra-European economic problems.

Regarding Marshall aid, the United States provided policy guidance and not merely money aid. This was a period in which Europe experienced a shortage of resources. In this context, our material

aid offset that part of the shortage which could be traced to an insufficient ability to import. But, as has already been said, European economic policies left much to be desired. There was no area in which this was more notably true than in the field of exchange and trade policy. This was one of the fields in which the United States used aid programs as leverage to win the Europeans over to sensible reforms. Specifically, we used the opportunity for cooperation provided by our participation in aid programs to hasten the shift away from the strait jacket of bilateralism in trade and payments.

At the beginning of the European Recovery Program (ERP) many European nations were trading among themselves under bilateral payments agreements with reciprocal credit arrangements. For instance, Britain and Switzerland might agree to an arrangement whereby each government stood ready to hold the other's currency up to a value of, say, \$25 million, but to have any excess convertible into gold or dollars on demand. The underlying assumption of arrangements such as the Anglo-Swiss payments agreement is that there would be only short-term or seasonal fluctuations in the current-account position of either of the parties. Actually, however, European countries have not all had realistic exchange rates or domestic policies compatible with equilibrium in the balance of payments. Countries with false exchange rates tended to become large permanent debtors of other European countries with fairly realistic currency values. (Of course, bilateral balancing of accounts would not occur in the western European situation, or elsewhere for that matter, even if there were correct exchange rates. False exchange rates simply would intensify the difficulties faced by the nations in the area.) Increasingly, the debtors became unwilling to pay in dollars or gold, and the creditors became equally unwilling to extend new credits to the debtors, so that more and more of the agreements degenerated into out-and-out schemes for bilateral balancing of the trade of each pair of trading nations. Total European trade shrank because, as is typically the case with bilateral deals, the deficit countries were forced to cut their purchases from every other country to the level of their sales to each such country. Even the European countries with roughly equal bilateral deficits

and surpluses were forced to contract their imports. Because of currency inconvertibility, they could not use their surplus with one nation to offset their deficits with another. Intra-European trade thus was subject to a growing paralysis.

After some experimentation, the ERP nations were given conditional dollar aid in an effort to overcome trade paralysis. Estimates were made of the bilateral trade account between each ERP country and the others a year in advance—estimates were made of France's account with Belgium, of Belgium's account with the Netherlands, and so on. Such estimates were intended to suggest plans for the maximum utilization of European resources. Once these estimates were agreed upon, the creditor country in each case committed itself to establish accounts in its own currency in favor of its debtor to the amount of the estimated deficit. These accounts were called *drawing rights*, and were made available as grants (gifts). For example, if Belgium was able to export to France the equivalent of \$50 million of goods in excess of the value of the estimated French exports to Belgium, the Belgian drawing rights in favor of France would be \$50 million. In the absence of outside aid, France, not holding Belgian francs and not having adequate gold and dollar reserves, could not buy these needed additional goods from Belgium. Under the intra-European payments plan, however, Belgium agreed to grant France drawing rights in Belgian francs up to the equivalent of \$50 million.

What is the connection between drawing rights and Marshall aid? Belgium, although a creditor of France, had a dollar deficit in her Western Hemisphere trade. Suppose that this amounted to \$150 million, and that this sum represented Belgium's share of aid for the year. Belgium did not get all of the \$150 million unconditionally. Of the \$150 million of total aid that Belgium was allotted by ECA during the year, \$50 million was conditional upon Belgium's granting the agreed upon drawing rights to France. That is, Belgium was required in effect to earn the \$50 million by providing aid herself to France in the form of goods paid for in Belgian franc grants. Thus, the intra-European payments plan made ERP

dollars do double duty. The first duty was to move goods between countries in western Europe. The second was to move goods from the Western Hemisphere to Europe as Marshall aid.

Cases comparable to the Franco-Belgian case just cited were repeated 78 times between creditors and debtors among the 16 ERP participants. Marshall aid under the intra-European payments plan could not be retained entirely by its direct recipients, but had to be passed on in part to other ERP nations. Conditional aid thus increased the total transfer of goods and services under the ERP. It should be noted that the real beneficiary of conditional aid was not the creditor country but the debtor country. Conditional aid was merely a way of paying the creditor in dollars for its surplus of exports to the deficit country. (Prior experience showed that the creditor was accumulating too much of the currency of the debtor, and therefore would provide additional goods only 'against a usable currency.)

From the beginning of conditional aid, it had been recognized that it might be necessary to modify drawing rights. It will be remembered that these rights were drawn up on the basis of *estimates* of bilateral trade balances made a year in advance. These estimates could be faulty. If so, conditional aid would work to force trade into an arbitrary pattern. Also, creditors might fail to charge their debtors fair prices against drawing right commitments. For example, the drive to increase efficiency in some export industries might be slowed down because high cost production was readily being sold under the conditional aid program.

In order to be prepared to correct erroneous trade estimates and to guard against overcharging, 25 per cent of the drawing rights were made transferable at the option of the debtor. The debtor country could transfer a fourth of its drawing rights spendable in Creditor A to another creditor country, B. Simultaneously, conditional aid corresponding to these rights would be withdrawn from A and given to B. Transferability enabled the debtor countries to shop around with their drawing rights in order to obtain essential commodities at the lowest prices. The record shows, however, that

the limited transferability of drawing rights did not intensify competition among intra-European creditors to the extent of significantly reducing costs and prices.

The intra-European payments plan just described was really a subsidiary means of distributing Marshall aid rather than a payments mechanism. For all practical purposes, Europe did not have a self-sustaining mechanism for handling intra-European payments. More accurately, it had no such mechanism except on an unsatisfactory bilateral basis.

#### NATURE OF THE EPU

Dissatisfaction with limited payments agreements and associated bilateralism prompted many governments to set up machinery that would restore multilateral settlements—at first, among the ERP nations themselves, and later perhaps on a world-wide basis. The machinery that we are to describe (in general terms) is known as the European Payments Union (EPU), which began operations in 1950.

The EPU operates as a technical, and not a policy-making, agency to facilitate trade among the western European countries. Specifically, it functions as an organ of the OEEC. Its outstanding characteristic is that it is a mechanism for clearing or settling *current* accounts among EPU members on a *collective* basis. Britain and France do not attempt to offset their franc and sterling claims bilaterally. Instead, Britain offsets current debts to France with credits held in the form of balances in EPU *currency units*. These British balances may have arisen from trade surpluses with the Netherlands or Denmark, or any other EPU country. In short, EPU members offset their debits against their credits *without regard to national currencies*. The EPU machinery thus restores the region-wide convertibility of western European currencies. This is a significant accomplishment, for which America, with its insistence upon economic integration, deserves much credit.

EPU is perhaps best regarded as a type of clearing house. Monthly the central bank of each country communicates to the

Bank for International Settlements (in Switzerland) the balances on its books in the names of other countries' central banks. Thus Britain's Bank of England shows balances on its books in the names of the Bank of France, the Bank of Italy, and so on. The Bank of France shows balances on its books in the names of the Bank of England, the Bank of Italy, and so forth. These balances are then cleared at the Bank for International Settlements. After they are cleared, there are likely to be net debit or credit balances: Britain may owe the ERP countries net, and France may find that the ERP countries owe her net.

How are these net balances settled? First, we must recognize that the balances represent liabilities to and claims on the EPU. Second, a formula has been worked out for the settlement of such balances. Each country has been granted an EPU quota. Except for two countries, each quota is the equivalent of 15 per cent of the member's total payments and receipts on current account with other members in 1949. The quota is expressed in terms of "EPU units," which are so defined that they equal one U. S. dollar. The settlement of net balances is determined by the size of the member's cumulative debit or credit balances relative to the size of member's quota. The mechanics of settlement are shown in Table 11.1.

#### **SETTLEMENT OF NET BALANCES**

To explain Table 11.1, let us first consider the situation during the initial two years of the EPU, namely, the period through June, 1952. It will be seen that the debit balances up to one-fifth of the member's quota were settled through the extension of credit by the EPU. Incidentally, the EPU was able to extend credit initially partly because the United States made a large grant of dollars to the union. The extension of credit meant, for instance, that if France's net debt to the union was just under 20 per cent of her quota, France did not have to make gold payments; the EPU extended credit to France up to this amount. Once France's debt exceeded a fifth of her quota, she had to begin making gold payments to the union. The proportion that had to be settled through

gold payments increased with the ratio of the country's net debt to its quota. Thus, as the net debt approached the limit of the quota, four-fifths of the net debt had to be settled in gold.

TABLE 11.1  
SETTLEMENT OF MEMBERS' DEBIT AND CREDIT BALANCES WITH EPU  
(in per cent of quota)

Per Cent of Quota	<i>Debtors through June, 1952</i>		<i>Debtors from July, 1952, to June, 1954</i>		<i>Debtors from July, 1954, to July, 1955</i>		<i>Debtors after July, 1955</i>	
	Pay gold to EPU	Receive credit from EPU	Pay gold to EPU	Receive credit from EPU	Pay gold to EPU	Receive credit from EPU	Pay gold to EPU	Receive credit from EPU
1st 10%	—	10%	—	10%	5%	5%	7.5%	2.5%
2nd 10	—	10	2	8	5	5	7.5	2.5
2nd 20	4	16	6	14	10	10	15	5
3rd 20	8	12	8	12	10	10	15	5
4th 20	12	8	10	10	10	10	15	5
5th 20	16	4	14	6	10	10	15	5

SETTLEMENT OF CREDIT BALANCES: Through July, 1955, creditors granted credit to EPU for net credits up to the first 20 per cent of their quota and then, for each quota bracket, they granted credit to the EPU equal to 50 per cent of their credit; after July, 1955, the creditors received a uniform 75 per cent of the net credit in gold and extended credit to EPU for the balance of their net credit.

Once a country's debt exceeded its quota, the nation was required to settle 100 per cent of the excess by gold payment. Such terms were imposed to induce the country in question to mend its ways.

An inspection of the table shows that the settlement terms were slightly modified during the two-year period after June, 1952, and then really "hardened." In the first change moderate debtors were required to make larger gold payments, but the larger debtors were enabled to settle with somewhat smaller proportionate gold payments than before. The terms of settlement when the debt exceeded the quota were unchanged as compared with the earlier period. Much more interesting was the change of 1954, which introduced a decided "hardening" of payment terms. For a year, debtors had to

pay 50 per cent of their net debt in gold, and could receive credit from the union only for the balance. No distinctions were made in terms of quota brackets. Further hardening occurred in 1955, when debtors were required to pay 75 per cent of their debt in gold, again regardless of the size of the debt relative to the country's quota. This 75-25 ratio still prevails.

Throughout, members received credit automatically from the union as long as their debt did not exceed their quota. That is, the credit was earned, so to speak, as a matter of right—members did not have to request credit or run the risk of being turned down by the EPU.

A word may be said about the member's inducements to adjust. In the early periods, the inducements took the form mainly of increases in the proportion of gold payments as the debtor country's net debt rose in relation to its quota. Later, the uniformly high ratio of gold payment to net debt was supposed to provide the inducement. In addition, the EPU's provisions requiring payment of interest on net debt have been another factor operating from the beginning to induce debtors to adjust their trade position. The interest payable to the union is at a rate that rises as debts continue to remain outstanding.

#### **SCOPE OF THE EPU SYSTEM**

We must now point out that the EPU extends to more than the area known as western Europe. This is because several of the European countries, but notably Great Britain, are themselves centers of a currency system that extends to overseas countries. To illustrate, the EPU extends to the sterling area and to the transferable-account countries as well, so that the clearing facilities of the union are open—by way of London—to sterling area and transferable sterling countries. In fact, Britain's position with the EPU is established on the basis of transactions between other OEEC countries and the sterling area as a whole. Clearly, the EPU system is of considerable scope geographically.



### THE EPU AND TRADE LIBERALIZATION

Before the EPU came into being, as we have indicated, most of the trade between OEEC countries was shackled by bilateral trade-quota agreements. Import restrictions were widely used to help balance payments bilaterally.

The creation of Europe's multilateral *payments* system did not of itself guarantee an expansion of multilateral *trade*. All the EPU system did was to remove the currency barrier to nondiscriminatory trade within Europe and other territories within European monetary areas. That is, with the EPU in being no member had to worry about its bilateral payments position with any other member; it had to worry only about its over-all position with the union. As has been shown, this was a big step forward.

An additional step was necessary—measures to eliminate or reduce import quota restrictions. To achieve this purpose the OEEC, in 1950, adopted a "Code of the Liberalization of Trade." This provided that each member was to eliminate almost immediately import restrictions on private trade amounting to 60 per cent of the 1948 value of the country's imports on private account from other members. The degree of liberalization was to be stepped up from year to year; at the time of writing, it averaged about 90 per cent, though some members had liberalized almost 100 per cent of their EPU trade. In some cases, however, there was greater liberalization in name than in fact, since increased liberalization was accompanied by special new import taxes having restrictive effects similar to quotas. Moreover, trade covered by state trading organizations has not been touched by liberalization. Nevertheless, the liberalization movement has been fairly successful, partly because the liberalization of quotas has been accompanied by more liberal administrative practices.

### THE EPU AND WIDE CONVERTIBILITY

The architects of the EPU envisaged the union as an interim arrangement which in due course would blossom into the European

segment of a fully convertible world payments system such as existed before the 1930's. No time table was established, however, for reaching convertibility. Instead, the OEEC has been used as a forum in which to apply pressure on members with lax monetary and fiscal policies so that they might press forward with greater measure of monetary restraint. The progress achieved was such, in fact, that when the OEEC approved the prolongation of the EPU in 1955 it also adopted a European Monetary Agreement.

The European Monetary Agreement is to come into force when countries accounting for more than half the EPU quotas make their currencies convertible. For example, Britain would "go convertible" if all nonresident sterling were put on the same basis as American-account sterling.

Before we discuss the highlights of the European Monetary Agreement (EMA), it will pay us to review the matter of the "hardening" of EPU in the form of the increase in the gold portion of monthly settlements to 75 per cent. This action was taken by the OEEC at the same time that it adopted the EMA. As far as convertibility is concerned, the significance of the hardening is this: it reduces the financial incentive for member countries to maintain discriminatory restrictions on imports from the dollar area. These restrictions, imposed initially in order to facilitate multilateral European settlements within the EPU, would have to be reduced if the countries were to move gradually toward convertibility. For convertibility would increase competition from the dollar area, as compared with a situation in which Europeans failed to buy American goods for lack of facilities with which to acquire dollars.

As compared with the terms of monthly EPU settlements before the gold-credit ratio had been made 75:25, the new ratio more closely approximated the conditions which would obtain under convertibility. This is essentially the reason why the hardening of the EPU was regarded as a step toward convertible currencies.

The EMA provides for two separate but complementary organizations. First, there will be a new arrangement for continued multilateral settlements between member countries. Second, a new

institution, known as the European Fund, will extend medium-term credit to nations in need of it. The code of trade liberalization is to continue, so that the advance toward freedom of payments and of trade may proceed along parallel lines.

The European Fund is of interest. This institution will extend medium-term credit (that is, for not over two years) but, in contrast to the EPU, not on an automatic basis. Rather, each country that had not been able to "go convertible" would seek credit on an *ad hoc* basis on grounds of need. A part of the European Fund's \$600 million available for lending will be funds left over from the original contribution of the United States to EPU. Each applicant must satisfy the European Fund (1) that it faces balance of payments difficulties of the sort which may endanger the country's level of trade liberalization, (2) that it is pursuing sufficiently firm domestic policies, and (3) that the interests of the OEEC as a whole will be safeguarded by the loan. Moreover, the borrowing country may be required to carry out specified recommendations before funds are advanced to it.

The EMA's settlement system may be contrasted with that of EPU. Under EPU, the same mechanism is used to clear funds multilaterally and to grant credit in terms of an agreed ratio of gold and credit. This credit, to repeat, is granted automatically. It is also granted for a period of undefined length. At the same time, very short-term credit is also provided during the month for which settlements are made. This credit takes the form of central bank holdings of other member countries' currencies. Such short-term credits end, of course, with the monthly settlements.

The EMA will also provide short-term credit, to be known as "interim finance." That is, the credit will be only for short periods between monthly settlements. Each country will agree to provide up to a stated limit of such credit during any one month. This will be done by having each central bank stand ready to buy and sell its currency up to such credit limit in terms of other members' currencies. Surpluses or deficits in the monthly settlements will have to be paid for entirely in gold or dollars.

There was an interesting clash of views over the new monthly

settlements system. Britain argued that the achievement of convertibility would end the need for any regional payments machinery. Most of the continental countries, however, held that a regional organization is needed for two reasons: First, the organization would serve to check independent action, mainly in the sphere of exchange rate changes, that Britain might take if she were not bound by membership in a regional system. Second, the maintenance of an organization would constitute insurance against any collapse of convertibility. The resulting compromise took the form of agreement on a more complex system of settlements than had prevailed before.

Let us elaborate. The British wanted settlements under convertibility to be made through the market mechanism, but the continentals felt it was necessary to preserve a clearing arrangement. We may partially explain the difference by again drawing a contrast with EPU. Under EPU, countries clear net balances at the par value of their currencies. Thus, continental countries holding sterling are paid by the union in the form of gold valued at 75 per cent of the net debt times the par value of sterling. The most radical departure from EPU in the new EMA is that monthly settlements are to be made at the exchange rate least favorable to the holder of the currency.

To determine this least favorable rate it is necessary for each central bank to decide the margins between its buying and selling exchange rates. Once the central bank of Country A has informed other central banks of the margins, A's central bank has to maintain them on a stable basis. And so on for Countries B, C, D, and others.

Let us illustrate the new situation under the EMA. Suppose that Britain decides to establish what is reported to be the maximum margin of permissible fluctuation for sterling, namely, 3 per cent above and below the \$2.80 parity. This would mean that sterling could fluctuate between \$2.71½ and \$2.88½. The EMA provides that monthly settlements are to be made at the exchange rate that is least favorable to the creditor. Suppose Britain is a creditor. Under EMA, the dollars due Britain will be transferred

through the settlement only at the selling rate for dollars of the *other* countries concerned, that is, the rate that gives the least dollars per pound sterling. However, Britain—as the creditor—would be holding the other currencies and hence, under the rules of EMA, would have the option of using the monthly settlement system *or* selling the currencies in the market before the end of the month. It would be to Britain's advantage to sell such currencies in the market rather than wait for the monthly settlement, since Britain will obtain fewer dollars by waiting for the reason that under normal conditions market exchange rates will lie well within the margins between the official buying and selling exchange rates.

This may be clarified if we label the illustrative margins for sterling cited above. The rate of  $\$2.71\frac{1}{2}$  is the rate at which the Bank of England stands ready to buy sterling (sell dollars), while the rate of  $\$2.88\frac{1}{2}$  is that at which the Bank stands ready to sell sterling (buy dollars). The former would be the Bank's selling rate for dollars, and the latter its buying rate. Thus, if Britain were a creditor she could dispose of her continental currencies at the monthly settlement at the lower limit cross-rate, equivalent to  $\$2.71\frac{1}{2}$ , whereas she would normally be able to do better in the market.

Conversely, if Britain were a debtor it would be the other countries that had the choice of converting their sterling at the monthly settlement or without delay in the exchange market. At the monthly settlement, they could convert only at Britain's selling rate for dollars, or  $\$2.71\frac{1}{2}$  in terms of the illustrative figures that we have been using. They probably could get more dollars in the market.

We may usefully set forth the following generalization: The wider the margins of permitted exchange-rate fluctuations under EMA, the greater the probability that intra-European payments will be cleared not at the settlements but between central banks at rates prevailing in the foreign exchange market. After all, the worse rate likely to be encountered by a creditor would be that prevailing at the monthly settlement.

**A SUMMING UP OF EPU AND EMA**

It will be helpful to recapitulate the main features of the foregoing analysis.

First, the EPU is a useful institution for achieving multilateral payments in that each member does not have to concern itself with its bilateral payments position with any other member but only with its over-all position with the union.

Second, the ratio of gold payments to automatic credit has been gradually increased since the establishment of the EPU. This "hardening" has tended to strengthen each country's inducement to adopt policies conducive to a proper balance of payments position.

Third, the EPU system covers a large part of the world's trade, and not just that of western Europe, by virtue of the extension of EPU to the sterling area and the transferable sterling system.

Fourth, the liberalization of European import quotas has been achieved in line with the expansion of the multilateral payments system.

Fifth, the EPU countries are not satisfied with a regional multilateral payments arrangement but wish to see the restoration of a genuine world-wide multilateral payments system.

Sixth, the members have therefore adopted a European Monetary Agreement which is to come into force when members having half of the EPU quotas make their currencies convertible.

Seventh, the EMA establishes a European Fund, which will extend credit only on an *ad hoc* basis instead of the automatic basis that characterizes EPU. The purpose of the credit, which is not to be for more than two years, is to enable borrowing countries to overcome temporary balance of payments difficulties and thus not endanger their level of trade liberalization in Europe. Because the European Fund may make borrowing conditional on the adoption of certain policies by the borrower, it will have a measure of supra-national authority not now possessed by other international agencies operating in the field.

Finally, the EMA fixes monthly settlements on such a basis that members are likely to find it preferable to repay interim finance before the end of the month, by purchasing the currencies they owe on the market at exchange rates that will normally be more favorable to them than those used in the monthly settlements. The emphasis thus is on self-help and the maximum use of market mechanisms.

#### **EMA AND THE TRIPARTITE MONETARY AGREEMENT**

Europe's blueprint for convertibility has been said to imply a desire to return to some of the general principles of the Tripartite Monetary Agreement, which governed the exchange arrangements between the United States and several key European countries in the late 1930's.

Three features of the Tripartite Agreement are of interest. First, each central bank, acting for its respective government, was at liberty to shift its buying and selling rates for its own currency in terms of other currencies on condition that it gave others 24 hours notice. Second, each central bank undertook to extend to the other central banks the short-term credit represented by the holding of other currencies, if and when it was asked to do so by buying and selling its own currency at the agreed rate. Third, the credit facilities were to be short-term and subject to limits informally agreed but strictly adhered to, and in addition at very short intervals any balances arising from the operation of the Agreement—that is, any credits extended under it—were to be repaid in gold. Some observers believe that the Tripartite Agreement might have developed into a permanent and workable system had not World War II intervened.

#### **THE INTERNATIONAL MONETARY FUND**

If meticulous planning of an organization by the experts guaranteed success, the International Monetary Fund (IMF) should be one of the world's greatest institutions. Instead, it is on the defensive after being in existence for nearly a decade, and one

official investigation has even gone so far as to recommend to Congress that the United States review the case to see whether the agency any longer serves the national interest.<sup>1</sup> Nevertheless, the IMF or some adaptation of it may yet play a useful role, especially since there are prospects that the free world may "go convertible."

The IMF, which started operations in 1947, is set up to administer a "code of fair practice" in the foreign exchange field and to make short-term advances to members to help them meet temporary deficits in their balances of payments. There are three general objectives of the IMF: (1) the elimination of exchange restriction, (2) the establishment and maintenance of convertible currencies, and (3) the widest extension of multilateral payments.

#### **ORGANIZATION**

A Board of Governors controls the Fund, one for each of the 60 member countries. Since, however, the Board only meets once a year, the day-to-day operations are under the control of a sixteen-member Board of Executive Directors which is in continuous session in Washington.

Five directors are appointed by the countries with the largest quotas (the United States, Great Britain, Nationalist China, France, and India) and 11 are elected for two-year terms by the other countries. Voting power of the directors varies with the size of the quotas of the countries they represent. The United States, with nearly a third of the quotas, controls nearly a third of the total vote.

#### **OPERATIONS**

The IMF's assets total nearly \$9 billion, of which about a third consists of gold and dollars. The rest is made up mainly of

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<sup>1</sup> See Commission on Organization of the Executive Branch of the Government, *Lending Agencies* (Washington, D. C.: A Report to Congress, March, 1955), p. 101. Recommendation No. 41 relates to the IMF.



inconvertible currencies, including some that are quite shaky.

Operations to date have been limited owing to the excessive demand for goods from the dollar area coupled with the slow pace at which most countries have set about to put their own domestic financial house in order. Thus, most countries have had balance of payments difficulties of a persisting kind, and they have found it necessary or desirable to impose and maintain exchange restrictions.

In its relations with members, the IMF has sought to do two things. It has sought to help them restore or maintain financial stability; and it has sought to reduce and finally eliminate exchange and other restrictions which have been maintained for balance of payments purposes.

The purpose of the Fund is to make temporary and not long-term loans. Basically, member nations are supposed to be opposed to putting up with persistent deficits in their balance of payments. When they encounter a temporary deficit, they are to draw on the Fund's financial resources to tide themselves over such a temporary situation, defined as a period of some 3 to 5 years. Since each member contributed gold to the extent of 25 per cent of its quota, the Fund freely permits a member to draw up to the amount of its gold contribution. In addition, the Fund is reasonably liberal in permitting drawing within the next 25 per cent of the member's quota, being satisfied if the member appears to be making a "reasonable effort" to solve its problems. Additional drawings are based on a more careful scrutiny.

Thus far some \$1.2 billion of drawings have been made on the Fund, of which about half has been repaid. Under the Articles of Agreement, a member is to use half of any net improvement in its reserves of gold and convertible currencies to pay its outstanding debt to the Fund. If these automatic repayment arrangements do not operate, or if members do not voluntarily repay the Fund (as has frequently happened), the Fund has the job of working out repayments within a three- to five-year period. In addition to out-

right drawings, the IMF has also made "standby arrangements" with members. Under these the Fund gives formal assurances of access to its resources up to a stated amount as needed.

The Fund charges a fee for its services. On its drawings the charge is  $\frac{1}{2}$  of 1 per cent plus interest charges on all amounts beyond the member's gold contribution. The effective interest rates range from 2 to 3.5 per cent, depending on the portion of the quota and the duration of the drawing.

#### **EVERLASTINGLY TRANSITIONAL?**

Members are allowed to impose restrictions on payments for current international transactions under Article XIV of the Fund agreement during "the postwar transitional period." This is a period which one writer has defined as a period of transition between one transition period and another! Clearly, the war caused great destruction in Europe and it was imperative that international agreements not block efforts to restore productive capacity. But European recovery was achieved within a few years of the start of IMF operations, thanks partly to generous United States aid.

Why, then, have members continued to invoke Article XIV, using the plea of balance of payments difficulties and dollar shortage to justify persistent use of discriminatory exchange arrangements? The basic answer is that there has been a persistent relative tendency to inflation in much of Europe and in many underdeveloped countries. That is, there has been continued inflation relative to the United States. The countries that persistently inflate find that they suck in too many imports and retain goods for local use that would otherwise be exported. In short, disorderly domestic finance results in persistent balance of payments difficulties.

What has the Fund done about the situation? It has held annual consultations with members about their exchange restrictions. Such consultations examine each country's situation to see whether

the country may feasibly eliminate its restrictions. But the Fund can only persuade, and it has almost no leverage with respect to the real source of trouble: domestic inflation. There has also been another problem. Great Britain, whose currency is the most widely used money in international trade and finance next to the dollar, has not been satisfied with the adequacy of her gold and dollar reserves. These are now less than they were in relation to trade in prewar years, so that Great Britain, whose importance in the world has greatly diminished, fears that she cannot assume twentieth century responsibilities on slender reserves. There is something to be said for her case, but the statement would have a more persuasive ring if truly effective measures were taken to avoid inflation.

#### **THE SCARCE CURRENCY CLAUSE**

The above relates to the slippery concept of balance of payments difficulties when the cause of the phenomenon lies outside the United States. But such difficulties may also be experienced by other countries, under certain conditions, even if the countries in question succeed in whipping the basic problem of inflation. Specifically, the difficulties could occur if the American economy should be markedly depressed. We would then be exporting relatively heavily and importing moderately, thus forcing others to dip greatly into their reserves to make good a true deficiency of dollars. This is the kind of situation that occurred in the depressed thirties, and the Fund has specific powers to deal with the contingency Article VII allows members to discriminate against a country whose currency is scarce in this special sense. However, there has been no occasion justifying the invocation of Article VII since the start of IMF operations. Instead, most of the world has been discriminating against our dollar under Article XIV.

#### **OTHER ACTIVITIES**

In addition to the foregoing, the IMF carries out a variety of activities. For example, it requires that members consult with

it if they wish to change their exchange rate, which can be done if the change is necessary to correct a fundamental disequilibrium—a situation that is almost a common occurrence in an age of inflation. Consultation with the Fund is also required if a member wishes to change its multiple currency practices (those in which exchange controls are used to enforce two or more values for the currency), or otherwise engages in discriminatory currency arrangements. The IMF also works in an advisory capacity with the GATT (an international trade-liberalizing body, which we will discuss in a later chapter), by supplying financial facts and information with regard to balance of payments justification of import quotas that are being maintained by GATT signatories.

Advice to governments is another function of the Monetary Fund. Studies by the Fund's staff in Washington help in this connection, as do technical missions that are sent to member countries on request to deal with matters of economic and financial stabilization. Finally, we may mention the Fund's publications, which provide financial statistics and studies that bear on exchange matters.

The world needs to be guided by the spirit of the IMF, even though some of its key provisions and its authority leave much to be desired.

### **A SUMMARY STATEMENT REGARDING UNITED STATES INTERNATIONAL MONETARY POLICIES**

The position of the United States with respect to the issues discussed in this and the preceding chapter has been stated indirectly and only in part up to this point. It will help to make a more positive statement.

1. *Exchange Control.* The United States is opposed to exchange controls except as these are used as essentially temporary expedients by countries in serious balance of payments difficulties. In fact, the United States has even sponsored a successful system—the EPU—under which the member countries liberalized their trade and payments with one another while maintaining discriminatory exchange

and other restrictions against dollar goods. We have also seen how the United States has cooperated with the European countries to get them to move gradually toward the long-run objective: a world-wide system of multilateral payments and fully convertible currencies. To this end, the United States has also encouraged others to adopt and maintain internal financial stability, without which multilateral payments would be just something at the end of the rainbow.

2. *International Mechanisms for Exchange Stability.* This country was the main sponsor and has been a key backer of the IMF, partly because of plural voting features which are favorable to the United States. The Europeans, on the other hand, are less enthusiastic about the Fund, and have preferred to approach a world-wide multilateral payments system through the process of trial and error and the more gradual route of the EPU and the European Monetary Agreement. Evolution along such lines has given rise to the partial restoration of a system of inter-central bank arrangements to deal with exchange-rate matters and the provision of short-term credit. In the meantime, the relative inactivity of the IMF hasn't strengthened its prestige. Thus, the world's progress toward multilateral payments may involve some sort of compromise in the form of a modified IMF or further evolutionary developments along the lines of the European Monetary Agreement.

3. *Exchange Rates.* At the end of World War II the United States favored rigid exchange rates and feared the resumption of competitive exchange depreciation such as prevailed in the depressed thirties. Since then there has been little evidence that countries were disposed to offer others bargain purchases by way of exchange rate inducements. Instead, nearly all the world—the United States included, to the surprise of many—has enjoyed high or brimful employment and faced varying degrees of inflation. There has been a “shortage” of real resources for the satisfaction of *home* demands for consumption and investment (and, of course, defense). In this context, the United States has favored a temporary use of free or fluctuating exchange rates to the end that such

a policy would help countries to find a stable rate that could be maintained without exchange control.

The United States has also opposed multiple exchange-rate systems. But it has been lenient in opposition with respect to countries, such as those in Latin America, which lack efficient fiscal and other administrative machinery. The emphasis in relations with such countries has been to move, slowly if necessary, in the direction of the progressive elimination of multiple rates.

The basic international monetary goals of the United States, thus, are exchange-rate stability and the full convertibility of currencies under conditions of freedom in foreign exchange markets.

### **PROBLEMS**

1. "The sterling area system combines elements from a great tradition with truly novel international financial arrangements." *Explain.*

2. "The pooling of all external foreign exchange and gold earnings by members of a multilateral payments system for their joint use in settling external deficits is the method of the sterling area and not of an EPU-type system." *Explain.*

3. "The £100 which a Briton holds in a London bank can be used to better advantage internationally than £100 of transferable sterling which is owned by a Brazilian and which he cannot convert into dollars except in a non-British market." *Evaluate.*

4. "The British must be foolish if they allow American-account sterling to be transferred to a resident account while disallowing transfers in the reverse direction." *Evaluate.*

5. "American-account sterling has always been convertible." *Explain.*

6. "Given the growing freedom of international commodity dealings and the wide use of sterling in international trade, the transferable and official sterling rates must tend to merge." *Explain.*

7. "European payments arrangements that preceded the EPU were not truly multilateral payments systems." *Explain.*

8. "The EPU required some measure of discrimination against the dollar area." *Explain.*

9. "EPU clearing facilities make it possible for other countries to

withhold their earnings of sterling from the EPU, sell sterling in the market and remain short of it for weeks. This is indeed a gift to the bear speculator." *Explain.*

10. "The prospective EMA system is designed to exist side by side with an active and free foreign exchange market." *Explain.*

11. "As we in Britain see it, the EMA's multilateral settlements arrangement reconciled considerably divergent interests and opinions." *Discuss.*

12. "Before the IMF could require a member to abandon its exchange restrictions it would be necessary to show that the member would not be likely to encounter a serious drain of foreign exchange reserves. But most countries would be quite willing to abandon controls under these circumstances." *Discuss.*

13. "Countries should cope with deteriorating external balances by reducing the pressure of domestic demand rather than by attempting to cut the pressure down at the frontier by means of intensified exchange or import controls." *Explain.*

14. "Looked at from the outside, the sterling area is a 'closed' economic system resting on controls that limit transactions with the rest of the world, but from the inside the area appears as an 'open' system within which trade and payments are subject to fewer controls than most international exchanges." *Explain.*







**PART IV**

**ECONOMIC NATIONALISM  
TODAY**

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## CHAPTER 12

# Protection

Everyone is in favor of competition in economic life—but for other businessmen, farmers, and workers.

When it comes to me and my affairs I'm likely to think and talk rather differently—especially if some import is cutting into my sales. Competition then appears to me to be “unfair,” “cut-throat,” and “destructive.” Those foreign exporters who are underpricing me are surely “dumping.” They probably don't pay their workers decently and certainly don't have my high taxes. What I need is some form of protection. Isn't that what my trade association is supposed to do? I'm going to write my Congressman!

If the reader thinks these attributed sentiments are exaggerated he should read some of the hearings on extensions of the Reciprocal Trade Agreements Act or on the application of the “escape clause” provision in most United States trade agreements. Nor is the American businessman, farmer, or worker markedly different, when it comes to organization against competitive imports, from his foreign rivals abroad. Almost everyone, it seems, wishes to invoke the power of his government to lessen the competition he faces from foreigners.

### PROTECTION TAKES MANY DIFFERENT FORMS

For centuries governments have sought to protect home producers by means of import tariffs, and these are still an important deterrent to trade. Immigration restrictions, designed to protect the

domestic labor force, also have long been imposed by a number of countries. However the twentieth century, and particularly the last 25 years, has given birth to more protectionist restrictions than a good free trader like Adam Smith could ever have imagined possible.

The following are some of the devices that governments have used to shelter home producers from foreign competition:

- Import duties
- Quotas and import licenses
- Import embargoes
- Exchange control
- Government purchasing preferences
- Subsidies to home producers
- Compulsory "marks of origin"
- Copyright and trade-mark enforcement
- Excessive valuations
- Unnecessary inconvenience in clearing customs
- Meticulous application of tariff classifications
- "Dumping" duties and "escape" clauses

#### **IMPORT DUTIES**

Although the following chapter describes different kinds of tariffs, and their incidence upon price and quantity, some points should be made here. A duty is usually a specific (dollars per physical unit) or *ad valorem* (percentage of value) tax on imports. Its effect is to reduce the quantity of a good imported because it raises the price to home buyers (which causes them to buy less) and lowers the net price received by foreign sellers (which makes them less anxious to export).

Not all imports are subject to a tariff. Every country has a free list, usually comprising raw materials processed by home industry, but also goods that are neither in competition with home output nor taxed for revenue purposes. Thus, in the United States, one finds such items as iron ore (used by the steel industry), newsprint (used by publishers), and ice (used by railroads) all on the free list. Urea is on the free list too.

Table 12.1 gives an idea of the value of goods imported under the free list as a percentage of the total value of all imports: there seems to be a tendency for this percentage to decline over the forty-year period. In 1953, the mid-year of the last five-year period, the value of free list imports was 5,919 million dollars and the value of dutiable imports was 4,859 million dollars. Total duties paid amounted to 584 millions: thus the average tariff rate on dutiable goods that were imported was about 12 per cent.

TABLE 12.1  
FREE LIST IMPORTS AS PER CENT OF  
TOTAL IMPORT VALUE

1916-20	67
1921-25	60
1926-30	64
1931-35	62
1936-40	60
1941-45	66
1946-50	58
1951-55	56*

\* Preliminary estimate.

SOURCE: *Statistical Abstract of the United States*.

It would be a mistake, however, to infer that United States tariff protection is moderate because over half the value of imports enter free. Actually, if one considers how short is the free list and how high the proportion of rather bizarre items on it, the surprising thing is that less than half the value of actual imports was dutiable. Clearly a great variety of dutiable goods that might have otherwise been imported entered in very small quantities or not at all. Similarly, an average duty rate on dutiable imports of 12 per cent may seem very moderate, but the statistics do not reveal how many goods at higher rates did not enter because of the tariff. The goods that do enter in quantity are generally those bearing a low duty rate. Hence the ratio of duty paid to value of dutiable goods imported seriously underestimates the restrictive effect of a country's tariff laws. That is perhaps why protectionists often cite this particular ratio when arguing that tariffs aren't really excluding imports but raising revenue instead.

### QUOTAS

Different kinds of quotas, together with their effect on price and quantity, will be described more fully in the following chapter. A quota is a quantitative restriction permitting only a given number of units of a commodity to enter the country during a given period. The administration of quotas usually involves the granting of licenses for prescribed quantities to different importers. As the effect of the quota is to raise prices at home the acquisition of such an import license is a matter of some moment to the importer. France was one of the first nations to make extensive use of quotas. However, the United States imposes quotas on, among other things, cotton, sugar, wheat, and a variety of dairy products. Farmers are influential citizens.

### EMBARGOES

Nearly all countries have imposed outright embargoes or prohibitions on certain imports, ostensibly as sanitary measures, to protect health and morals. The United States Tariff Act of 1930, for example, required the absolute embargo of all animals and meats from all regions of any country in which rinderpest or foot and mouth disease exist; thus all Argentine beef has been excluded from the United States although the region of Patagonia is free of these diseases. Foreign books and movies are often held to be immoral or subversive even though the home-produced counterparts are equally lurid and inciting. The United States excludes all foreign flag and foreign-built ships from coastal and inter-coastal traffic, and other countries do the same thing.

### EXCHANGE CONTROL

The United States has never exercised peacetime control over the foreign spending of its residents. However, almost every other

nation in the world—notably Great Britain, Argentina, and some other Latin American countries—have at one time had stringent systems of control that can be used not only to limit total imports but also to divert imports from one source to another. Hence, although the nominal object of exchange control is to restrict *all* transactions that give rise to payments—whether these be trade, investment, or exchange transactions—the attainment of this goal inevitably and drastically affects imports. Thus the administrators of a nation's exchange control make trade policy as much as do its legislators.

The operations of an exchange control have been described in Chapter 10. Suffice it to say here that all exporters, among others, must turn their foreign exchange earnings over to the control; and all importers, needing foreign exchange, must either obtain it from the control or obtain a license from it to buy the foreign exchange from a dealer. Before approving such a request the control will want to know what is to be imported and from what country. If the exchange-control country is low on dollar exchange, and the desired import is to come from the United States, the application for dollar exchange to finance the transaction will probably not be approved. If the application is part of a proposal to import automobiles, and there is a domestic automobile industry that would like more sales, the "need" to conserve foreign exchange for more "vital" purposes may be the excuse for disapproval. If there are national airlines and shipping lines it may be difficult to obtain exchange to travel on other aircraft and ships. Foreign companies that have accumulated earnings in domestic balances may be discouraged by only being allowed to transfer a fraction of them annually: this has happened to American movie companies in Great Britain, for instance.

A country that has a thoroughgoing system of exchange control has no need of tariffs except as a means of raising revenue. From a protectionist viewpoint, exchange control is superior to a quota system as a means of restricting imports, because this can be done with less publicity by approving or disapproving the numerous



daily applications for foreign exchange. Any kind of import or country of origin can then be discriminated against with less probability of retaliation than if the same ends were sought by means of tariffs or embargoes.

#### **GOVERNMENT PURCHASING PREFERENCES**

The central and local governments of most countries spend a fair fraction of the national income; thus, in the United States the various public authorities spend at least a fifth of the net national product. A considerable fraction of this expenditure is for military equipment, machinery, supplies of all kinds, and services such as overseas transportation, that could be obtained from foreigners. Should the government buy from the cheapest source or should these appropriations be spent to support home producers?

Congress has expressed itself in the Buy American Act of 1933. This law, born of severe depression, lays down the rule that goods for public use shall be purchased only from domestic sources unless this is "inconsistent with the public interest or the cost is unreasonable." We may note that this act has determined policy even in periods in which there were acute shortages and inflation.

For many years an administrative rule interpreted "unreasonable cost" of domestic goods as an amount 25 per cent or more above the cost, including duty, of foreign goods landed in the United States. In 1954, however, President Eisenhower personally conceived and proposed to his Cabinet a more liberal formula. This he made effective as an Executive Order. Under this Order, contracts are to be given to foreign low bidders when the lowest domestic bid is from 6 to 10 per cent higher than the lowest foreign bid. Certain exceptions were laid down, the chief of which provides that a greater differential may prevail in cases in which the domestic bidder operates in a community with above-average unemployment. Manufactured equipment often presents special problems under the Buy American Act. Thus, it is frequently debatable with respect to such equipment whether the home and foreign products are really equivalent. Hence, the determination of the percentage price dif-

ference can become a matter of judgment by officials who are subject to political pressures.

Government purchase preferences also occur outside the scope of the Buy American Act. For example, Congress has also required that 50 per cent of the tonnage exported under the military and economic aid programs shall go abroad in American ships. For a long time the Navy has been prohibited from purchasing various provisions from cheaper sources abroad. During World War II a certain percentage of the wool in military uniforms had to be home grown. What is the moral of all this? It is that as central governments buy an increasing share of the national product this method of protection is likely to be resorted to more often and its incidence on the taxpayer becomes more significant.

#### **SUBSIDIES TO HOME PRODUCERS**

Most governments subsidize some home enterprises, either in order to decrease reliance upon imports or to earn more foreign exchange through exports. Thus Germany, before the last war and as a preparedness measure, subsidized the output of certain farm products (such as beet sugar and cereals) and the construction and operation of certain war industries (such as synthetic oil and rubber plants). Export bounties have been paid by some European governments, on one product or another, since the seventeenth century. In countries where the railroads are nationalized it is sometimes provided that exports shall move to the ports at preferential freight rates. Today all the major powers subsidize their shipping lines and aircraft lines in one way or another. In some cases an outright "countervailing" or "compensatory" subsidy is paid to "equalize" costs. In other cases high mail subsidies may be allowed. The most obvious effect of all subsidies and bounties is to reduce imports and increase exports to some extent. The economic effect is usually that the nation's resources are allocated a little less efficiently. Incidentally, especially in the case of commodities, the best counter move to a subsidy allowed by a foreign government may be to impose a duty on the import; then the final result is that most or

all of the subsidies paid by the government of the exporting country are collected as customs duties by the government of the importing country.

#### **COMPULSORY "MARKS OF ORIGIN"**

Foreign producers have sometimes imitated domestic goods and "passed them off" as local produce of an importing country. These transgressions have been seized upon as a justification for requiring that the country of origin be clearly marked on imports of certain kinds. The effect is to restrict the importation of these goods. First, the cost of marking may be considerable, especially if customs officials go so far as to require, say, every bottle *and* cork in a case of wine to be marked "Made in Italy." Second, the importer does not always know in advance what will be accepted as a proper country designation by capricious customs officials: instances have been known where shipments were turned back because they were marked Burma rather than British India, or because the designation was, strangely enough, in the language of the exporting country. Third, especially after a war, it is hard to sell an import that clearly originates in a recently enemy country: and at any time there are some people who feel it is somehow unpatriotic to buy imports.

#### **ENFORCEMENT OF TRADE-MARK LAWS AGAINST IMPORTS**

Nearly all countries have laws against the infringement of patents, brand names, and copyrights within the country. If the value of a patent is not to be seriously undermined it may be necessary to prevent the importation of goods that embody the patented feature but the foreign manufacture of which has not been licensed by the patent owner. The same reasoning has been applied to trade marks and copyrights. However, there have been instances where this rationale has been extended to remarkable lengths. Thus there have been cases, especially in the field of cosmetics and perfumes,

of our firms buying the "American rights" to some well-known foreign brand name. Then, should the original product be imported from abroad, the customs may confiscate the shipment unless all brand marks are removed. (Of course it is later difficult to sell a bottle of perfume that bears no label.) It is surely a far cry from the original intent of the patent laws that an American company, by purchasing the American rights to a foreign brand name, can invoke the power of government to exclude all imports of the original product, when labelled, into the United States.

#### EXCESSIVE VALUATION OF IMPORTS

There is evidence that customs officials, in assessing *ad valorem* duties, are more often encouraged by their superiors to make high than low estimates. Most countries, including the United States (as we shall see in detail in the next chapter), seek to use a foreign value, but the complaint is sometimes made that it is the retail price rather than the manufacturer's price abroad that is taken as a basis of valuation. In a few cases it is alleged that the estimated "foreign" value includes the insurance and freight incident to bringing the merchandise to the American customs shed. Protectionists have sometimes argued that the proper value is the price of equivalent articles in the importing country: if this view were accepted there would be few if any imports. Whether or not imports are impartially assessed, it is clear that the importer can only very roughly guess in advance the *ad valorem* duty that he will have to pay: this uncertainty in itself can be a powerful deterrent.

#### UNNECESSARY INCONVENIENCE IN CLEARING CUSTOMS

Some countries, including many of the less developed ones, have a bad reputation for deliberately delaying customs clearance, losing or ignoring invoices, and damaging the goods or the packaging in inspecting them. A few countries used to insist that parcel post containing dutiable merchandise be cleared through customs

at the frontier—hundreds of miles away—with the addressee or his agent personally present. Even in the United States, when imported merchandise addressed to a private party comes by freight, it is usually necessary as a practical matter for him to hire a customs broker.

#### **METICULOUS APPLICATION OF TARIFF CLASSIFICATIONS**

The tariff classifications of most customs laws are extremely complex. A particular import may seem to be equally well described by different classifications that apply different rates. In general, the more labor that has gone into the merchandise, the higher the rate: thus handkerchiefs trimmed with lace are likely to have a different *rate* than just handkerchiefs. A great source of difficulty and uncertainty is that many goods comprise different materials, having different duty rates, and there must be a decision as to which is the component of chief value that will determine the classification. Some imports are really assemblies of different parts, the identities of which are not lost in the assembly: if these parts carry different rates, which shall apply? One favorite atrocity case concerns an imitation bird in a cage: is it a toy, or a musical instrument, or a manufacture of feathers and brass, and, if so, is the important constituent feathers or brass? This case illustrates the fact that the uncertainty of not knowing sometimes what rate will be applied discourages importation, particularly of novelties.

#### **"DUMPING" DUTIES AND "ESCAPE" CLAUSES**

Most countries have special anti-dumping laws that authorize the government to impose emergency duties or quotas to prevent "dumping" by foreigners in the home market. In the popular eye "dumping" is believed to take the form of sale at a low price. It is also regarded as "selling below cost" and sometimes as "selling at a price that will substantially injure domestic producers." Technically, however, it can be defined as price discrimination between two or more national markets; in other words, it is the sale of a product

for export at a net price lower than that charged domestic buyers, at the same time and under similar conditions of sale.

The Anti-Dumping act of 1921 requires the government to determine, on complaint, whether the price of an imported product is below its "foreign-market value" (or, in its absence, "cost of production"), if an industry in the United States is apparently being injured or prevented from being established because of the dumping. After an affirmative finding, a dumping duty is levied, equal to the difference between the "foreign-market value" and the "purchase price." Incidentally, the domestic industry does not have to be *materially* injured for there to be a determination of dumping—mere injury is sufficient.

Clearly, just the possibility that "dumping" will be held to exist offers some protection to home industry, since uncertainty is increased for the foreigner. But there is more than this to the matter. For example, importers are not allowed to complete customs formalities on the mere suspicion of dumping, so that an allegation of dumping by domestic competitors has the effect of a temporary embargo. The resultant investigations have resulted in losses on perishable products awaiting clearance through customs.

There is another aspect to the determination of "injury." In nearly all industries, save perhaps those dominated by a few large corporations, there are some firms that are a little "submarginal" in the sense that they make a loss in more years than they make a profit. At each and every price of imports there will be some such firms. If a sympathetic government is always concerned over the fate of those firms that are currently submarginal, it will always be trying to raise the home market price, and so always attempting further to restrict imports.

For the last decade or so our government has weakened the effect of the Reciprocal Trade Agreements program by inserting "escape" clauses in such agreements. The Tariff Commission, on its own motion, or on request by an interested party, the Congress, or the President, is required to investigate whether a proposed or actual tariff reduction has injured, or is likely to injure, an American industry or prevent its establishment. If the President fails to follow

the recommendations of the Tariff Commission (whose terms of reference are set forth along narrow protectionist lines) within 60 days, he must file an explanation with the relevant committees of the Senate and House. Usually the President bases his action on broad considerations of the national interest. Hence, up to the time of writing, he had accepted only a very few of the tariff increases recommended by the Tariff Commission. One of the most notorious duty increases was that against Swiss watch movements, it being widely believed that this increase was partly motivated by a desire to aid the re-election of a Senator from Massachusetts.

It cannot be stressed too much that frequent litigation over customs matters, uncertainties, and delays are a great deterrent to international trade. Until a shipment is cleared through customs, the importer often cannot know within sometimes wide limits what the duty will be. Worse still, exporting companies that develop a market for their goods in a foreign country are usually living under the threat of politically inspired action against them. If the importing business does too well, outraged producers in the home market of the importing country will ask their government to impose special restrictions. For the foreign exporter it is a game of "heads I lose, tails you win."

### **LABOR UNION ACTIONS AGAINST IMPORTS**

Though restrictions imposed by governments are more important, there are also private actions that hinder imports. Thus, longshoremen at times have refused to unload products coming from certain countries. More importantly, some collective bargaining agreements specifically restrict management's rights to purchase foreign goods. For example, the International Ladies Garment Workers Union has exacted financial penalties from companies with which it has agreements, because such concerns imported blouses from Japan in violation of contractual obligations to make all blouses in union shops. Clearly, such purely private contractual arrangements, if expanded in scope, could constitute a serious obstacle to the formulation and implementation of appropriate foreign economic policy.

### WHO IS FOR AND AGAINST PROTECTION?

Broadly speaking, the people who favor protection are those who supply agents of production, whether labor, capital, or natural resources, to enterprises that would normally have to sell their output in the home market in competition with imports. The special interests that favor freer trade are usually those who supply productive agents to enterprises that could probably sell more exports if foreigners were only able to earn more local currency through increasing their exports. The general interest of all consumers is freer trade but this—for reasons explained in the final section—is politically less important than the clash of special interests.

Thus, in the United States the owners of lumber mills, and their workers, and the people who own timber land within the country, are all in favor of protection against foreign logs and lumber. However, tobacco growers, the owners of the land employed in raising tobacco, and the people who work the land, favor freer trade into the United States because this would enable European countries to earn more dollars, some of which would be spent on American tobacco. The stockholders and employees of American companies making cash registers and electronic office equipment would like more general free trade for the same reason. The automobile industry has generally favored a more vigorous Reciprocal Trade Agreements program because any agreement that lowers United States duties on foreign cars for lower foreign duties on American automobiles is likely to help Detroit. But the textile communities of New England and many in the South are very much in favor of protection for their products.

The United States companies that have an absolute advantage in money costs of production, which is usually associated with a comparative advantage in terms of labor and other real costs, are not afraid of competition in the home market and feel capable of expanding sales in foreign markets if only the foreign buyers can earn more dollars. The domestic companies that are internationally at a disadvantage, so that they have no hopes of exporting and



constantly fear for a contraction of their sales at home, want more protection for their output. As might be expected, firms whose existence can be economically justified find protection more of a hindrance than a help: firms for which there is little economic justification, even though very efficiently managed under the circumstances, want and need protection if they are to survive.

Of course, within a given industry, there are various special interests opposed to one another. Thus most American firms *selling* watches would really like to see the free importation of watch movements, for which they usually supply the case and the advertising: it is the few *makers* of watch movements within the United States that want higher tariffs on this product. Lumber mills that do not own large tracts of timber land in the United States may be in favor of free importation of logs but protection for lumber. Some of the large oil companies that have developed extensive reserves of petroleum abroad may be in favor of free trade for crude, while independent petroleum producers in Texas may organize to obtain higher tariffs on petroleum: the same major companies however, with refineries in the United States, may be in favor of protection for petroleum products such as gasoline and fuel oil. So it goes.

It is quite erroneous to suppose, say, that all labor is for freer trade and all corporate managers are for protection. Labor in the automobile industry usually feels quite differently about these issues from labor in the textile industry. One of the features of the last decade is the number of businessmen and union leaders—of certain export industries of course—who have supported freer trade before Congressional committees. Thus the Detroit Chamber of Commerce has favored extensions of the Reciprocal Trade Agreements Act and has even urged free trade. On the other hand, certain new industries in the South—long considered the center of free trade interests in the nation—are inclined towards protection; examples are plywood and textiles.

It is quite erroneous too to suppose that all tariffs benefit all Americans while all measures to free trade merely benefit foreigners. The conflict of interest here is not between the residents of one

nation and those of foreign countries. The real clash is within the country, United States protection benefiting some Americans at the expense of others, while freer trade would benefit other Americans.

Always in the background is the general interest, inarticulate and unheeded, that favors any and all measures that put resources to work where they make the greatest contribution to gross national product. If the composition of this national product does not exactly suit consumer preferences there is always the possibility of trading exports for imports. That is why peoples have traded for thousands of years.

### **ECONOMIC ARGUMENTS AGAINST PROTECTION**

The general argument against protection is the positive case for free trade. There is a *prima facie* case for unrestricted trade among nations that rests on the analysis of Part II and especially of Chapter 3 and need not be repeated here. There are, however, some supplementary considerations that will be mentioned.

#### **IT PREVENTS TRADE WHICH IS GENERALLY BENEFICIAL**

If an exporter wishes to sell to a buyer who wishes to import—and there is no coercion in either case—it seems rather obvious that the trade is mutually beneficial to the two parties involved. It makes no difference whether or not the exporter is the original producer and whether or not the importer is the eventual user. That the two parties should have sought each other out and made a contract, thereby surmounting linguistic barriers, geographic distance, and all the uncertain hazards of the trade and financial controls imposed by governments, strongly suggests that the transaction holds every promise of being profitable for both. Users do not habitually buy goods from another country, just as producers do not usually sell them to another country, if they can do so as profitably at home. The burden of proof is certainly on anyone who asserts that international trade, whether in goods or services, is *disadvantageous* to both participants and therefore should be restricted.

Is it possible though that international trade transactions, while beneficial to both the parties involved, are in some way harmful to one or other of the two economies? The history of protection is replete with arguments that seek to show that this can and does happen under a variety of circumstances. The most familiar and serious of these arguments are explained and examined in Chapter 15. Most of them are either invalid or depend upon an improbable combination of factors.

Nevertheless there are a few exceptions in which the self-interest of the traders does not coincide with that of the economies in which they live. International trade in certain drugs, contaminated foods, and pornography are examples. However, in these cases the object of import restrictions is not protection but quarantine. Unfortunately many ostensible acts of quarantine are not clearly warranted and have a protectionist motivation.

Exceptions of a more economic nature may exist from the general rule that free and profitable trade is beneficial to both economies. If the costs to the producer are artificially low—which would be the case if he were receiving a subsidy from his government—the trade may not really benefit the *exporting* economy. If the costs of producing the imported good at home are artificially high—which would be the case if there were a domestic excise tax on its manufacture—the tax-free entry of this good might not benefit the *importing* economy on balance. Most of the valid interferences with international trade arise in cases where the local cost structures are in some way unreal. Protection may then be needed to compensate for other government interferences with the economy.

It was pointed out in Chapter 3 that the relative factor endowment of national economies differs, and that the effect of international trade, whether in final products or in factors of production, is to lessen or eliminate international price differences for each productive factor. Protection of any kind has the opposite effect. If Australasia has a comparative advantage in meat production, because of its abundance of grazing land and small population per square mile, a reduction in its meat exports will lower the value of grazing land still further and so in effect make this comparatively

abundant factor seem more abundant. Similarly, the countries that import meat because of their relative shortage of grazing land will find that the value of this land is still further increased by protection, so that in effect this scarce factor appears still scarcer. International trade has the extremely important effect of lessening any price inequalities of factors of production among nations. Protection has the effect of accentuating these inequalities. Here again, in each case, the burden of proving that this is desirable lies upon the protectionist.

#### **IT PRESERVES INEFFICIENCY**

Most of us believe that competition among domestic producers continually forces them to find new ways of improving their products and reducing their costs of production. Is there some peculiarity concerning international trade that invalidates this rule when rival firms are located in another country? If foreign firms are not allowed to compete with home producers, will the latter remain fully efficient?

There is no reason for supposing that, if competition from a Toledo firm increases the efficiency of a Cleveland firm, competition from a firm in Milan, Italy, will not have the same effect; in fact, other things equal, this Italian competition will surely be equally disliked by the Cleveland firm and equally good for American buyers. In recent years, to give two examples, we have seen the competition of Italian manufacturers force an improvement in American sewing machines and in British lightweight motor cycles.

There is always some danger that the principal firms in an industry, especially if the home market is small, will evolve a comfortable way of life that involves only limited competition. In Europe particularly, restrictive practices abound in many trades and industries, and even though no collusion may exist the tradition is often one of live and let live. New methods of production are not used, new uses for old products are not promoted, and service to customers is perfunctory. Many of these attitudes and practices could not survive free trade. They are preserved by protection.

**IT LIMITS THE CONSUMERS' CHOICE OF GOODS**

At a time when scientists are making travel and communication among nations increasingly easy, protectionists are restricting the variety of foreign goods available to domestic consumers. Thus, through exchange controls, quotas, and tariffs, the availability of American movies, clothing, and durable consumer goods to European buyers is severely limited. Conversely, import restrictions limit the availability of foreign movies, books, magazines, pictures, furniture, clothing, and food to Americans. Imported products often import ideas and styles and others' ways of living. They enrich life. It is a tragedy that, at a time when the world is growing smaller in one sense, narrowness of taste and ignorance of fine things should be perpetuated by a policy of protection.

**SOCIAL ARGUMENTS AGAINST PROTECTION**

Economic science is not responsible for all the objections against protection. Poetic justice has decreed that pleas for protection, so often based on grounds of national defense, native ethos, or other elusive intangibles, must withstand a number of onslaughts which are likewise social in nature. Three of the more serious of these charges are that import obstruction tends to corrupt domestic government, disrupt national unity, and embitter international relations.

**CORRUPT DOMESTIC GOVERNMENT**

It cannot be repeated too often that a government grants a subsidy when it obstructs an import. It is not surprising, then, that an investigation of how tariff schedules are enacted tells a story of legislative lobbying. Almost every item in a tariff list records the successful use of pressure tactics.

Democratic government has taken many centuries to evolve, and even today it flourishes in only a few countries. One of the principal objections to the forms of government that it has replaced is

that they resulted in economic privilege and discrimination. Kings used to dispense monopolistic patents to their personal favorites. Oligarchies have existed to protect their own vested interests. We do not want any democratic government to become the tool of special interests.

Unfortunately, protection is partly responsible for the unhealthy state of political affairs in many countries today. Protection against imports is still one of the most important financial privileges that the state can grant. Consequently, the peacetime foreign trade regulations of most central governments have been manipulated to some selfish end. It is a sad day when democratically elected governments permit themselves to become in turn the agent of this and that special interest against the general welfare. Yet this is exactly what usually happens when the national government imposes a tariff, subsidizes ship construction, sets a quota on farm produce, or refuses to buy less expensive goods because they are produced abroad.

#### **DISRUPTS NATIONAL UNITY**

Certain areas of a country often specialize in producing one or a few favored products. These regions naturally have special interests which often clash with those of other regions within the same nation. The selfish struggles that ensue tend to disrupt national unity.

The tariff history of the Dominion of Canada furnishes an example of the strains and stresses that may develop. The provinces of Ontario and Quebec have long had greater manufacturing ambitions than the unprotected Canadian market could sustain in the face of British and American competition. However, the voting strength lies in Ontario and Quebec, and so, by means of protection, the Canadian market for certain manufactures was in large measure turned over to those two provinces. This Dominion policy has created especial hardships and ill-feeling in the Pacific Coast province of British Columbia. The output of this province's forests, fisheries, and mines cannot normally be absorbed by Canada. Moreover, the finished goods produced by Ontario and Quebec are usu-

ally less varied and higher priced than those of the United States, and they must move over a more expensive land route. British Columbia's prosperity, which should depend primarily on north-and-south trade with the United States, has been sacrificed to that of other parts of Canada. This continuing source of irritation has vexed a number of Dominion-Provincial negotiations and has to some degree disrupted Canadian unity.

Some countries suffer from this problem more than others. It is especially pressing when productive specialization is associated with geographical divisions. Various parts of a country may be concerned with only one or two products, the markets for which are mostly abroad, whereas other parts may make goods that by their nature must be sold in a more immediate vicinity. The contention of interests can then be organized with greater ease, and the final clash will be more pronounced. It is interesting to recall that the American Revolution can be partly attributed to the attempts of a short-sighted king to impose an unnatural trade pattern on his empire. Political unity and economic realism must always march hand in hand.

#### **EMBITTERS INTERNATIONAL RELATIONS**

When a tariff is raised against an import, the principal suppliers in other countries are confronted with either the loss of some of their business or the necessity of accepting a lower price. Insult will be added to injury should protection take the form of an embargo based on alleged danger to health or morality. To make matters worse, a very large percentage of most imported commodities come from one or two principal foreign nations. This concentrates the resultant ill will in a few countries, and since producers are politically dominant in most lands, retaliation is a probability. The same spirit may lead to successive countermeasures in return. Recourse may then be had to other kinds of economic discrimination against the goods and nationals of the unfriendly country: immigration quotas may be reduced or work permits denied; sometimes serious tension develops.

Political and economic relations between nations seem to improve

and degenerate as one. Thus, the European Coal and Steel Authority tends to bind Germany to France as the Benelux Customs Union tends on the whole to integrate Belgium and the Netherlands. There is relatively little danger of war between countries that voluntarily become each others best customers. On the other hand, arbitrary refusal to buy from a country is almost inevitably the cause or effect of diplomatic coolness. Normally, Argentina's relations with Great Britain are much warmer than with the United States, because the British buy Argentina's principal exports, whereas we prefer to exclude her fresh meats and impose severe tariff barriers on other products.

The history of the Reciprocal Trade Agreements negotiated by the United States Department of State gives grounds for believing that important tariff and quota concessions reinforce good will. Today there is an increasing realization in America that the political accords reached by the United Nations to promote peace must be supplemented by economic ties. Such ties can be bound more tightly by following policies of freer trade.

### WHY IS PROTECTION SO EXTENSIVE?

That author is suspect who blandly ignores the world of protection around him and continues to write that interference in international trade is valid only in rather exceptional circumstances. To some this may seem unduly theoretical and doctrinaire. But what is practiced is not necessarily desirable. The fact of war does not render peace an invalid aim. However, in order to satisfy the querulous and sceptical, let us explain why there are so many tariffs and quotas. The reason lies in the incidence of protection and the mechanics of politics.

A tariff or quota always benefits a particular trade or locality, such as business owners, workers with special skills, and perhaps material suppliers and local tradesmen. A change in the tariff law will vitally affect these people. The protected product may be their sole source of income. The style of living they can afford is contingent upon the level of the customs rate. Moreover, the capital values



of the specialized assets owned and employed in the protected trade are similarly dependent on the success of political maneuvering by their owners.

For example, there is a very close connection between the American tariff on wool and the value of certain classes of grazing land in the United States. If wool were imported duty free, there would be a considerable fall in the price of wool, which would in turn reduce the gross revenue of sheep ranchers. Some of the productive agents employed by them could successfully resist any attempts to lower the prices they are paid. Most of the labor would move to other jobs and places rather than accept a wage cut. Equipment manufacturers would concentrate on the other farm implements they usually make. But a great deal of grazing land, especially if too wooded for cattle, has no alternative use. Much of this land might no longer be able to command a rent, and its capital value would therefore be wiped out. A reduction in the wool tariff would not only slice the income of sheep ranchers but also confiscate a large part of the wealth invested in grazing land. Under the circumstances it is not to be wondered at if sheep ranchers organize to exert strong pressure on their congressmen.

On the other hand, the domestic injury inflicted by the wool tariff is almost widespread enough to escape perception. The textile firms which buy wool are hardly affected because they pass on the inflated price when they sell. The consumers of wool products admittedly suffer, but the percentage price increase is lost to view behind the many other costs of manufacturing; besides, woollen goods are only one of a hundred-odd products which consumers buy in a year. Nor do the users of wool goods have any capital assets at stake. These final consumers do not have sufficient incentive to organize, and they are too numerous and scattered to unite.

People sometimes wonder why consumers as a whole do not maintain a permanent lobby and apply continuous propaganda against all tariffs and quotas. Perhaps the wool tariff is an insignificant burden to consumers, but to this must be added such obstructions as the tariff on wheat, the embargo on Argentine fresh meat,

the duties on cameras and electrical equipment, and so on *ad infinitum*. A wide range of commodities purchased by any American family is price-sustained by a tariff or quota. One might think that the aggregate loss to consumers would justify the expense of counterorganization. The practical difficulty, though, is that the political issue as debated by a legislature is never that of free trade versus protection for *all* commodities. Such controversy as there is usually centers at any one time around only a few items; some small group is always vitally concerned in these, but the general public is not, and so loses the contest by default. Nobody will take time to guard the general interest when other matters affect him more directly and vitally.

Congressmen, Members of Parliament, and other elected officials should not be censured too harshly. They are not intellectual giants and must be pardoned if they succumb to the principal arguments they are likely to hear—namely, those presented by the lobbyists who favor protection. Elected officials have limited means for testing public opinion and must be excused if they believe that the favorable letters and telegrams drummed up by special interests are a truthful reflection of public opinion. And most politicians need financial and organizational help if they are to win elections. Most constituencies are economically specialized, and so there are always local trade associations or other organized groups resolved to elect a man who will secure or maintain protection for their commodity. This will be true not of one constituency but of all districts which elect legislative members. It is not surprising that these men will engage in logrolling when they assemble to pass tariff laws.

The existence of tariffs and quotas is not a proof of their desirability. It evidences the frailty of human nature and intellect. That so many governments practice a high degree of protection should occasion little wonder. It is but one of many mistaken and selfish public policies which can eventually be remedied through public education and a greater willingness to vote the general welfare at election time.

### PROBLEMS

1. "An importer faces many uncertainties before his goods are cleared through customs, and these uncertainties inhibit imports, especially when customs officials are capricious." *Exemplify.*

2. "No foreigner should be allowed to sell his goods in this country below his own costs of production plus freight and duty." *Evaluate.*

3. "It is unfortunate for our economy that the issue of more or less protection seldom comes up as such in Congressional Committee hearings—the issue is usually whether this or that product needs more protection." *Explain.*

4. "In countries having discriminatory exchange controls the legislators have practically abdicated to the exchange control officials when it comes to matters of trade policy." *Explain.*

5. "If free traders would examine the facts they would see that this country has almost no protection against imports: last year, for every \$100 worth of goods imported, \$60 were on the free list and the other \$40 paid only \$10 of duty." *Evaluate.*

6. "Some states which recently required apparel stores to place signs in large letters over their windows which read 'Japanese Textiles Sold Here' violated the federal Constitution." *Evaluate.*

7. "The uncertainties and vexations associated with over-refined and over-zealous customs administration may come close to killing competition in trade." *Explain.*

8. "Tariff schedules alone, even when diligently dissected, tell only part of the story of barriers to trade." *Explain.*

9. "It is unfair for Detroit to urge free trade when the textile industry of our state requires more labor per dollar of output than characterizes production in the automobile industry." *Evaluate.*

10. "The case for high textile protection is simple: American textile workers are the highest paid in the world and, as such, constitute far greater consumers of this world's goods than their foreign counterpart anywhere." *Evaluate.*



## CHAPTER 13

# Tariffs and Quotas

Tariffs and quotas—briefly described in the preceding chapter—are the two principal ways in which most governments exclude imports as a matter of commercial policy. While both of these devices result in protection, each has certain special features as regards administration. And their immediate incidence upon home buyers and foreign sellers tends to differ.

### THE CUSTOMS AREA

The customs area of a nation is the territory into which imports cannot legally be brought without “going through customs” and complying with such tariff and quota or other import regulations as may exist.

The customs boundaries of a nation are not always identical with its political frontiers. There are often islands or dependencies which may or may not be included within the customs area of the motherland. Thus, the customs area of the United States includes the territories of Alaska, Hawaii, Puerto Rico, and all her other overseas territories except Guam, Samoa, and the Virgin Islands. Where two countries are joined in a customs union, as have been the Kingdom of Belgium and the Grand Duchy of Luxembourg for many years, there is a single customs area for two sovereign states. In many countries there are a few restricted areas set aside as free zones for the convenience of businessmen and as an encouragement to *entrepôt* trade. We have free-trade zones, for example, in

New York, New Orleans, San Antonio (for air traffic), Los Angeles, San Francisco, and Seattle.

Free zones serve important needs. A shipment of some special type of tea is possibly due to arrive at the Port of New York. The importer, although relying heavily upon the home market, is also perhaps in the business of selling tea abroad. However, for various reasons the importer may have to repack or reship the tea that is destined for re-export. He might not be able to afford to engage in this kind of business if he had to pay the customs duty on the entire shipment he received. Accordingly, certain wharves and warehouses at the Port of New York are technically outside the customs area. In such places merchants engaged in entrepôt trade can break down the incoming cargoes, repack and reship the goods which are to be sent on, and pay duty only on those units actually imported and cleared through the customs. In many countries trade of this kind is rather important, and the profits of the middlemen so engaged have contributed so much to the nations' balance of receipts that the governments concerned have been glad to make special arrangements for free zones.

In other cases the national government has instituted a system of export rebates instead. The following case illustrates how such a system operates. The tea importer pays the requisite duty on every pound of tea that comes into the customs port and is given a certificate indicating the quantity he has brought in and the sum paid. He is then entitled, should he export the identical or equivalent goods, to a proportionate rebate of the total customs he paid previously. In this way the importer avoids any unwarranted financial burden should he subsequently re-export.

Rebate regulations vary from country to country. In some places there is a time limit within which receipt holders must apply for rebates. Occasionally rebates are transferable, in which case they may be sold to other exporters. This latter possibility may have unexpected consequences, particularly when a single nation imports a given commodity over one frontier and exports the same kind of good over another of its boundaries, or when one grade of a commodity is imported and another grade exported. In both cases

the effect of transferable rebates is to lower the effective import duty and partially to subsidize exports. The administration of a rebate system is often complex, but the commercial community is becoming more and more accustomed to complicated government paper work.

Governments are sometimes reluctant to establish free zones because of smuggling possibilities. And in some countries governments and traders are not prepared for the paper work necessitated by some rebate systems. In such cases bonded warehouses may be the answer. Imports stored in bonded warehouses pay customs duties only when the goods are released from bond for domestic consumption, while exports from bonded warehouses are like re-exports from a free zone.

### KINDS OF TARIFFS

Customs duties are of several kinds; as to form, three classes are distinguished: specific duties, *ad valorem* duties, and combined duties.

Specific duties are levies of so many cents per physical unit (pound, foot, number) of commodity. In contrast *ad valorem* duties are stated in terms of a percentage of the value of the imported commodity. Measured as a percentage of the value of the merchandise, *ad valorem* duties do not change in relative burden with changes in the price of imported merchandise. In periods of depression specific duties thus become more protective, whereas the reverse is true in periods of inflation. Combined specific-*ad valorem* duties may specify that one or the other, usually whichever involves the lowest charge, is payable at the customs. But sometimes, in an attempt to adjust automatically to price level changes and ensure some minimum levy, governments impose *both* specific and *ad valorem* duties.

The basis of valuation for *ad valorem* duties differs among countries. First, imports may be valued for customs purposes on the basis of price f.o.b. port of origin in the foreign country, which is the method employed by the United States. Second, the *ad valorem*

duty may be applied to the c.i.f. (cost, insurance, and freight) value of the goods—that is, to the f.o.b. value plus insurance and freight—which is the most popular method of valuing imports for customs purposes. Finally, there is the method of assigning arbitrary values to each class of merchandise to which the *ad valorem* duty is applied, and this method clearly can be abused by protection-minded officials.

Tariffs may also be classified with respect to country of origin. Three classes again may be noted: single-column tariffs, multiple-column tariffs, and conventional tariffs.

The single-column tariff is one in which only one tariff duty is established by law for each and every commodity, regardless of the country of origin of the goods. Such a tariff is a single-column tariff by virtue of the fact that a single duty is listed in a column opposite the enumerated tariff-commodity classes. Several Latin American countries have such tariffs.

The double- or multiple-column tariff is one in which, for each commodity class, two or more duties are established by law and depend on the category of the country of origin. Some of the British Dominions have such tariffs. For example, Australia generally utilizes the following three columns: general, intermediate, and preferential, with the preferential rates applying to British Empire goods, and the general rates to all other countries except those with which special tariff agreements have been signed, in which case the intermediate duties apply.

The most common tariff, however, is the so-called conventional tariff. Under such a tariff a basic duty is established by law for each commodity class, but each such duty may be reduced by international agreement. When the reduction is widely *generalized*—that is, granted to other countries as well as to the signatories of the agreement—the result is virtually a single-column tariff, in the sense that the reduced rate is practically the only effective one. The United States, Sweden, the United Kingdom, and others have this type of tariff. However, when duties reduced by agreement are not widely generalized, multiple-column duties result.

So-called *revenue tariffs* are sometimes distinguished from so-



called *protective tariffs*. However, this distinction, when it can be drawn, pertains more to motive than effect. Nearly all tariffs yield some customs duties, and all tariffs inhibit imports to some extent. Actually, if the rate of some given duty were steadily raised from a very low to a very high level, increasing revenues would be associated for a while with decreasing imports; however, above a certain level, the increasing duty rate would result in both decreased revenues and decreased imports. Thus there is a certain rate that will maximize revenues and higher rates that will exclude more imports.

Historically, it is true, customs have been a very important source of revenue for most countries—they are usually easier to collect than internal excise taxes. Thus about 98 per cent of the revenues of the United States in its earliest years were from customs: there is now a complete reversal, with over 98 per cent of revenues coming from non-customs sources. Today, customs are an important source of government finance primarily for comparatively backward economies such as India or for island dependencies such as Tahiti.

Of course, if there is an internal excise tax on, say, the manufacture of bicycles, an equivalent tax must be levied on imports of bicycles, not to protect the home industry, but to prevent what in effect would otherwise be a subsidization of imports. And when duties are levied on goods that are not produced at home, as for example on tea imports into Great Britain, the object is clearly revenue rather than protection. Inasmuch as tariffs always inhibit imports to some extent and because there are home produced substitutes for most imports, it is best to beware of people who advocate tariffs, not for protection, but “only for revenue.”

### VALUATION OF IMPORTS

Imports must be valued before *ad valorem* tariff rates can be applied and the customs liability calculated. Even when this is not necessary—as in the case of goods paying a specific duty—values are usually required for statistical purposes. The valuation of im-

ports is in practice an extremely complicated matter often involving unresolved issues of principle.

For example, should the import valuation be based on the "fair" value in the country of origin, or in the country of shipment (not necessarily the same), or in some neighboring country just outside the customs area? Should the valuation in the foreign country be based on the manufacturing, wholesaling, or retailing price? Should the value in the foreign country include excise taxes that are levied on goods for final sale in that country if they are remitted on exports? Should the value of imports include the freight and insurance cost of bringing them to the customs shed of the importing country? Should values inside the receiving country be the basis of valuation? And in any case, how are prices or values in practice determined for heterogeneous goods having no regular market, such as *objets d'art*, yachts, and specially constructed machinery?

Perhaps the best way to deal with these issues is to discuss them in terms of the topic of *indirect* protection as it prevails in the United States. Indirect protection refers to the expenses and outlays (other than customs duties), the uncertainties, and the delays involved in seeking to import goods in conformity with regulations established under a variety of statutes. These expenses, uncertainties, and delays may be the unintended result of poorly drawn or poorly administered regulations; or they may be burdens lawmakers have deliberately imposed as a sly means of discriminating against foreign goods.

*The Agencies Involved.* Responsibility for administering the Tariff Act lies with the Treasury, and specifically with the Bureau of Customs of that Department, so far as day-to-day operations are concerned. The negotiating of trade agreements that fix tariff rates is in the hands of interdepartmental committees advising the President. (This will be described later.) On the judicial side, the Customs Court hears appeals from decisions of customs officials. Finally, there is the Tariff Commission, which is a fact-finding and advisory body that reports to Congress and the President. As the Congress usually prescribes customs procedures in great detail, despite the

diversity and complexity of trade, appeals to the Customs Court are both numerous and significant. In fact, customs litigation is an important and not unusual part of our importing procedure.

*Entry and Liquidation.* Entry of goods and the release of merchandise from customs are essential preliminaries to importation. When goods are entered, specified information, mainly about source and value, must be supplied by the importer. It is on the basis of such information that an estimate of the duty is obtained. This estimated sum is deposited on entering a shipment. But the amount in question is not necessarily the final sum due. The estimate may involve an overpayment. More likely, however, is a less pleasant kind of surprise: a bill from the Collector of Customs for an additional amount.

The amount of duty finally payable is not known until the entry has been "liquidated." Liquidation of the entry requires (1) a report from the customs appraiser to the collector concerning the value of the goods, (2) a determination by the collector of the rate to be applied and the corresponding amount of the duty, (3) a check of the entry by the office of one of seven regional comptrollers of customs, (4) the deduction of the duty from the sum deposited by the importer at the time of entry, and (5) the payment, if necessary, of additional duty.

The duty determined on liquidation is final unless fraud is shown, an appeal is filed, or a protest is made. An important point to note here is that liquidation does not always occur soon after entry. Years may elapse, not because the customs service is inefficient, but because of the intricacy and archaic nature of customs laws.

The importer usually secures the release of his goods upon payment of the estimated duty. If he is dissatisfied with the duty that has been fixed, he may file a protest with the collector who then has 90 days to review his decision. If the collector does not change his decision, the protest is heard by the Customs Court. An appeal may also be made from this Court's decision to the Court of Customs and Patent Appeals and, very infrequently, to the Supreme Court.

The importer is not the only party that may choose to appeal decisions of the collector. Competing domestic interests also have the right to protest and to appeal. Thus, domestic producers of competitive products may complain that too low an appraised value is attached to an imported product, or that it has been wrongly classified. Sometimes such complaints are soundly based. Often, however, they simply create uncertainty, force importers into litigation, and discourage importation. If competing domestic producers were denied the right to appeal decisions of the collector, customs administration would be greatly simplified. For example, the customs administration could then quote a rate of duty and basis of valuation in terms, say, of a sample shipment. Clearly, this would do much to lessen the number of disputes and delays arising from them.

Because of the volume of appeals, there is a backlog of tens of thousands of cases in a normal year. In fact, the Customs Court in recent years has been able to dispose of only some 10-15 per cent of pending cases. We are a long way from a satisfactory customs administration, one feature of which should be prompt and equitable determination of import duties.

*Classification.* An outstanding characteristic of classification in the United States is that duty rates differ greatly in terms of highly technical and small differences under thousands of headings. This is in contrast to the case of many other countries, which have simple tariff classifications and small differences in rates among the categories in which a commodity may be classified. Here, the effective tariff rate may easily be 100 per cent higher than the lowest reasonable applicable rate, depending on such characteristics as weight, size, and method of manufacture. For example, containers for toilet preparations may be taxed at from 12½ to 25 per cent *ad valorem*, depending on the way the container was manufactured. There is a difference, for instance, if molten glass is *automatically* fed into jar-making machinery.

Our trade agreements have increased the complexity and ambiguity of tariff classification. Under the Tariff Act of 1930, Wilton rugs and "like material" as well as velvet carpets and "like material" were

dutiable at 40 per cent if valued at not over 40 cents per square foot. A trade agreement reduced the rate on velvet rugs and carpets of like character to 30 per cent, while Wilton rugs retained the 40 per cent rate. As a result, it has been necessary for the Bureau of Customs to determine whether rugs of "like material" are like Wilton or like velvet. Decisions in rug cases of this type require much time and are hard to make since the differences as between such rugs are largely a matter of opinion.

The case of radar illustrates how classification affects importers of products that were not known when the 1930 tariff was enacted. The duty on a radar set would be \$4.50 plus 65 per cent if classed as a measuring device but at the much lower rate of 25 per cent if classified as an electrical instrument. It required litigation over a number of years to have the lower rate apply.

What can be done about these and related classification problems? Action should concentrate on the wide spread between rates. If there were only a small range of duties in our tariffs, that is, if none or only a few duties were at high levels, there would be little point in worrying about small differences in related tariff classes. Thus, if one item was dutiable at 10 per cent and a similar item at 11 per cent, the difference would be unimportant. If hundreds of related items were placed in a single rate class, the Bureau of Customs' classification decision could easily be rendered without involving traders in much uncertainty and delay. Reform measures, therefore, might first reduce maximum rates, after which there could be a reduction of the number of rate classes. Action along such lines is long overdue.

*Valuation.* Uncertainties, costly delays, and expensive surprises are also involved in determining value for duty purposes. The United States has four general methods of determining value. These are (1) foreign value or (2) export value, whichever is higher. If these are not satisfactorily ascertainable, then (3) "United States value" is used. If none of the foregoing is ascertainable (4) "cost of production" is to be employed.

"Foreign value" involves particular difficulties, since it is so defined that importers and customs officers cannot know what it is

without a costly and time-consuming investigation that often ends in litigation. The law defines this value as the price abroad "at the time of exportation . . . to the United States at which such or similar merchandise is freely offered for sale for home consumption to all purchasers . . . in the usual wholesale quantities and in the ordinary course of trade. . . ." This definition contains a veritable hornet's nest of problems.

The foreign value must be sought for each commodity imported, or reasons given why it cannot be found. The export value is only sought if no foreign value can be established. According to the courts, there can be only one foreign value or export value at any one time and place. The problem thus is to find which, if any, of the many prices in a foreign country is *the* foreign or export value. Unfortunately, the "export value" is also defined by statute to include the troublesome phrases "such or similar merchandise," "freely offered," and the like.

Consider the meaning of "usual wholesale quantities." The courts hold that this means the quantity involved in the largest number of transactions at wholesale—not the quantity in which the largest total of sales is effected. In some smaller countries, for example, the usual sale is less than car lots. But this basis may be unfair to the American importer when exports to the United States are in car-lot quantities carrying a quantity discount. In fact, after years in the courts a case involving a large purchase of Canadian plywood was decided against the importer even though small-lot sales accounted for only 5 per cent and large-lot sales for 95 per cent of the volume of business in the product. This is heavy and erratic protection indeed.

The meaning of "such or similar merchandise" depends on criteria that usually cannot readily be applied at the customs. It is almost unbelievable how much of a customs fuss can be created over small distinctions between a product as sold abroad and exported to the United States. The difference may consist only of the kind of container used. Generally the upshot is increased protection.

In addition, the definition of foreign or export value involves

more or less tricky distinctions centering around the terms "principal market" and "country from which exported and time of export."

As between "foreign value" and "export value," the latter seems to be less objectionable. This is mainly because the former relates to sale for home consumption whereas the latter relates to sale to the United States. Hence, the latter usually is a lower value and is usually more ascertainable. However much in the way of simplification and liberalization needs to be done in either case. This need is particularly great because the great bulk of our dutiable imports are valued in terms of one or the other of these two bases.

The statutory alternatives to foreign or export value are even worse. The "United States value" obviously inflates the base upon which duty is collected, since the United States price at which the product is sold usually reflects not only comparative disadvantage in production at home in the United States but also includes ocean freight and domestic wholesale markups. If United States value cannot be ascertained the value must be based on cost of production. This basis may be used to value the initial shipment of goods to the United States, goods imported from a branch plant abroad for further processing here, or goods sold abroad and in the United States under exclusive arrangements. Establishing or verifying costs is generally difficult and hence appraisal is much delayed. Moreover, the law and procedure often have the effect of including in costs items that ordinarily are not included.

Pressure from the foreign trade community long troubled by these man-made procedural barriers has finally borne fruit. We refer to action by Congress in 1956 in introducing some simplification of valuation procedures. The basic change was to eliminate the "foreign value" basis of valuing imports as far as most of our dutiable imports are concerned. At the same time, the more troublesome phrases "such or similar merchandise," "freely offered," "usual wholesale quantities," and the like were redefined and clarified.

It is instructive to note that Congress was impressed with the duty-raising effect of the old valuation bases. In fact, Congress saw to it that the shift to "export value" (or the two other bases) and its newly defined constituent terms would not apply to some domes-

tic industries. Specifically, the new valuation bases are not to apply when the result is a reduction in dutiable value of 5 per cent or more. The commodities that would be so affected are given preferred treatment, in the sense that the old "foreign value" and its fuzzy constituent terms are to apply. Hence, as things now stand we are operating on a dual valuation system, with old, more ambiguous and more protective standards applicable to one group of commodities and a modernized set of standards applicable to all other dutiable imports. But the net effect is nevertheless to reduce man-made barriers to trade. Moreover, as this is being written, Congress awaits a thorough study by the Tariff Commission. This might provide the basis for across-the-board customs reform.

### KINDS OF QUOTAS

Initially quotas were employed as a particularly drastic means of protection but they have increasingly become an adjunct of exchange control. Five types of direct import quotas may be distinguished. These are (1) tariff or customs quotas, (2) unilateral import quotas, (3) import licensing, (4) bilateral quotas, and (5) mixing quotas. We shall describe each type, and then consider the effect of quotas on international trade and prices as compared with that of tariffs.

#### TARIFF QUOTAS

The tariff or customs quota is a device whereby a certain specified quantity of a particular commodity is permitted to enter the country under a special low rate of duty, but *any* additional amount is free to enter at a higher rate of duty. This type of quota thus combines the features of both the fixed quota and the ordinary tariff. An example of the tariff quota in the United States is that on butter. The regular tariff on this product is 14 cents per pound. However, under existing trade agreements the tariff rate on butter is seven cents per pound on imports from November 1 in any one year to March 31 of the following year, on a quantity not to exceed



50 million pounds during the quota period. This period is our season of low production.

Among the various types of quotas, the tariff quota probably has the longest history. By the middle of the nineteenth century several European countries had employed the device to encourage small but fixed amounts of frontier trade at a rate of duty lower than the general tariff. During the past several decades, however, fixed import quotas have tended to replace tariff quotas in most countries.

There are two important objections to the tariff quota. First, when imports exceed the quantity permitted under the low rate, the gains from the low rate go almost entirely to the firms that are exporting to us. Second, the rush of products into the United States at the beginning of each new tariff quota tends to upset prices in our markets. Take, for instance, our experience under the tariff quota on cattle before World War II. The Canadian quota was on a quarterly basis, and each quarter the Canadians would rush cattle into our markets in order to take advantage of the lower tariff rate on limited shipments. The result was to depress cattle prices, particularly on the St. Paul market, to the disadvantage of both Canadian and American farmers.

#### UNILATERAL IMPORT QUOTAS

The *unilateral* import quota is an absolute limit on the importation of a commodity during any one period, imposed without prior negotiation with foreign governments. Such a fixed quota may be a *global* quota, in which case the commodity can be imported from any country up to the amount of the quota, or it may be an *allocated* quota, in which case the total of the quota is divided, in advance, among specified supplying countries or specified home importers.

The global quota, the earliest of the unilateral import quotas to find wide use, has proved unsatisfactory in most cases. First, there results a competitive rush to fill the quota each time it becomes

open. Suppliers in distant countries are placed at a disadvantage, particularly in continental Europe. Second, large importing firms, which are able to order a large quantity on short notice because of trade connections and good credit, are placed at a decided advantage compared with small importers. Third, the rush to get commodities into the quota country may result in periodically oversupplying the market, especially in perishable goods. Prices, therefore, may be subject to greater fluctuation than would be the case in the absence of the quota. Fourth, since the mad rush to enter first often results in imports exceeding the permissible limit, monetary penalties are imposed, storage costs are incurred, and reshipment to the country of origin may even be involved.

In Europe, the introduction of the allocated quota was partly due to unsatisfactory experience under the global quota, but there were other reasons. Some countries deliberately wished to discriminate in favor of particular foreign countries. The mere imposition of an allocated quota by a major importing country may provide it with a valuable bargaining weapon. British quotas on meat and dairy products, for example, severely limited the freedom of action, in commercial policy matters, of such countries as Argentina and Denmark. In order to avoid evasion of country quotas by importation through third countries, however, allocated quotas generally include strict regulations relating to the national origin of imports. Another reason for restricting imports on an allocated quota basis was the desire of the quota country to retaliate against countries that had been treating their trade unfairly.

Allocated quotas generally involve considerable economic and administrative difficulties. Except where a policy of discriminatory treatment is being followed, the allocated quota is usually based on the percentage contribution of supplying nations in some preceding (base) period. This involves reference to a former *representative period*. But the demand for a particular nation's product varies from year to year. A given country's exports often are dependent on the vagaries of the weather; costs and prices also vary with time. This difficulty appears in intensified form if the export

statistics of some countries include goods originating in other countries and passing through them only in transit. A second shortcoming of the allocated quota is that it makes possible monopoly-like action among those exporters who are assured of a definite share of the quota.

Import restrictions on sugar, fixed annually by the Department of Agriculture, illustrate an allocated quota. Congress sets a sugar allotment for our mainland and territorial producers. The import quotas for foreign producers, which are assigned one year in advance, are determined by deducting this fixed domestic allotment from the nation's expected total consumption during the coming year. Public hearings are held in November before the Agriculture Department's sugar branch. Producing groups invariably estimate low consumption, so that import quotas will be low, and thus almost insure insufficient supplies in relation to demand. Consuming groups generally estimate high consumption. After the hearings, the Department announces its own official estimate, which is generally near that of the producers.

#### **LICENSING OF IMPORTS**

Import licensing was introduced in many instances as a means of improving the administration of the global quota.

A licensing system prevents the rush to import, which, as we have seen, was a characteristic disadvantage of the global quota. Licensing systems attempt to accord equality of treatment to different importers, mainly on the basis of each firm's business in a previous representative period. As with the allocated quota, however, the use of a single base year works an injustice upon many individual importers. Particularly difficult are the problems arising out of seasonal fluctuations of individual commodities, changing conditions of supply in different supplying countries, and license applications of new importing firms.

Nevertheless, a system of import licenses represents a decided improvement upon the global quota. The scramble to import be-

fore the quota is filled, the excessive fluctuations in prices, and the favoring of large firms are reduced. In addition, excessive profits can be taxed away by the auctioning of licenses, thus bestowing indirect benefits on consumers as taxpayers.

#### BILATERAL QUOTAS

European experience with import quotas showed that foreign producers are likely to take monopoly-like action as soon as a definite quota has been assigned to their country. One attempt to combat such monopolistic exploitation of importing countries was to negotiate quotas with foreign producers, and allow the administration of licensing to be handled by the exporting country. Because such quotas were the result of negotiation between the importing country and the exporting country (or foreign export groups), they have been called *bilateral quotas*.

The advantages claimed for the bilateral quota as compared with the unilateral type are: (1) that foreign governments or export groups have a greater interest in preventing imports from exceeding the global quota; (2) that provision can be made to have exports spread evenly over the quota period, thus avoiding excessive fluctuations in imported supplies; (3) that export monopolies can be excluded by agreement; (4) that participation by foreigners in the administration of licensing tends to reduce their opposition to the imposition of quotas; and (5) that licensing by the exporting country eliminates the difficulties associated with appeals and pressures coming from importers in the quota country.

The principal objection to the bilateral quota is that it tends to fall into the clutches of existing international cartels. The fact that the administration of export licensing under the bilateral quota is often entrusted to private organizations, such as chambers of commerce, makes the quota arrangement easy prey for well-organized cartels. Then too, because the bilateral quota usually results in raising prices in the export country whenever administration of the quota is by the export country, importers as a class stand to

lose. The national treasury also loses, since profits on import transactions are transferred from domestic to foreign firms and are thus excluded from the tax base.

### **MIXING QUOTAS**

Among the increasing number of nominally domestic measures that have had a serious impact on international trade, one of the most important is the type of regulation that limits the proportion of foreign-produced material that can be incorporated in domestically finished products.

Thus, Brazil requires that a certain percentage of the weight of bread must consist of domestic mandioca flour, and Great Britain requires the use of a minimum of domestic flour in all breads. The United States has legislated that 50 per cent of foreign aid goods shipped abroad shall move in United States bottoms. In artistic fields Britain has specified the percentage of domestic films that must be shown on British screens—35 per cent in 1956—and a Latin American country has enacted that one musical composition by a native citizen must be played at every concert. But mixing quotas are usually applied in the case of commodities, and the long list includes textile fibers (raw wool and synthetic fibers), liquid fuel (natural gasoline and alcohol), beverages (coffee and chicory), tobacco (domestic and foreign leaf), and rubber (natural and synthetic).

Except for the case in which the mixing quota is designed to relieve a country of complete dependence upon a foreign monopoly, these regulations clearly thwart the aim of distributing resources according to the principle of comparative advantage. The result is that prices are generally higher than they should be, and there is a considerable deterioration in the quality of the products involved.

### **THE INCIDENCE OF TARIFFS AND QUOTAS**

Who, if anyone, "pays" a tariff or quota, and in what way? This question concerning the immediate incidence of tariffs and

quotas is different from one regarding their ultimate cost in terms of misused resources. It is also easier to answer.

Almost without exception it can be said that the effect of a tariff or quota is to (1) reduce imports, (2) raise the price to users at home, and (3) lower the price received by foreign producers. Also, if there is home production, there will be the additional effects of (4) higher prices and (5) increased sales for domestic producers. Finally, because someone will pocket most of the difference between the prices respectively received and paid by the producers and users of imports, there will be either (6) extra government revenues—in the case of tariffs especially—and so perhaps some tax relief for other classes of taxpayers or (7) extra profits—in the case of quotas only—for those permitted to import.

Figure 13.1 illustrates why these results come about. The D

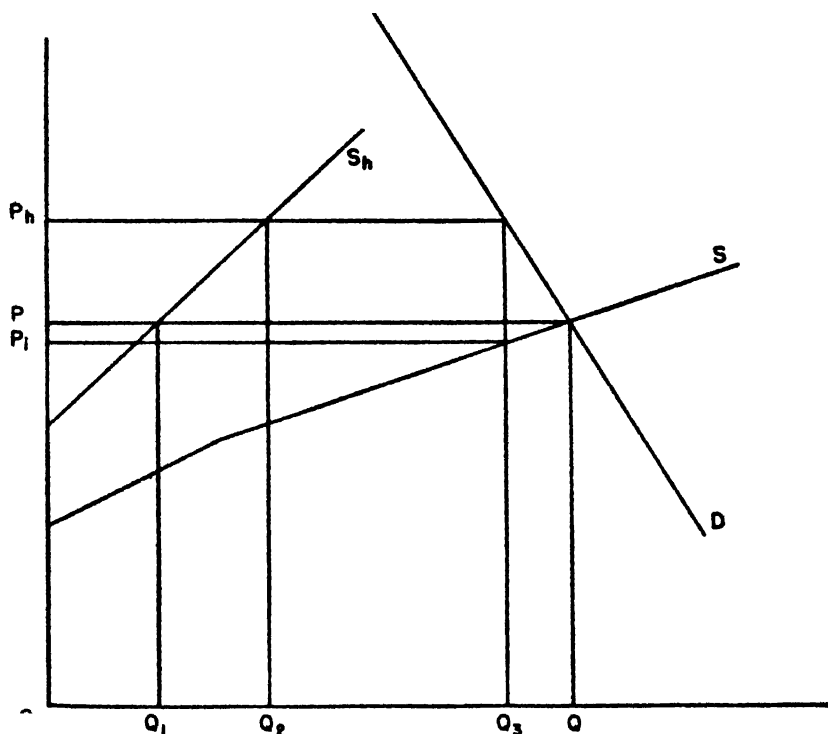


Figure 13-1. Incidence of comparable tariff and quota.

schedule represents the home demand, the  $S_h$  schedule the home produced supply, and  $S$  the sum of imports and the home supply. Thus the horizontal distance between  $S$  and  $S_h$  represents the quantity of imports at each several price. If there were no tariff or quota the price would be  $P$ , the total amount bought  $Q$ , home production  $Q_1$ , and imports  $QQ_1$ .

If a tariff of  $P_h P_1$  per unit were imposed on imports, the home price would rise from  $P$  to  $P_h$ , stimulating home production to increase from  $Q_1$  to  $Q_2$ . The net price to importers, after paying the duty, will fall from  $P$  to  $P_1$  and the quantity of imports will fall from  $QQ_1$  to  $Q_2 Q_3$ . The total use of this commodity will fall from  $Q$  to  $Q_3$  units. There will be government revenue equal to the product of the duty ( $P_h P_1$ ) and the quantity imported ( $Q_2 Q_3$ ).

If a quota were imposed, similarly limiting total imports to  $Q_2 Q_3$ , the various price and quantity effects should be the same. However, there will be no customs duties as such for the government. Who, then, gets the full home price that is paid by domestic buyers on imports and home production alike?

Ordinarily it will be the importer—rather than the foreign producer—who gains this extra price and profit, because the home price is now  $P_h$  rather than  $P$ . The importer, who makes the extra profit, is normally the man who secured the needed import license. Under the circumstances an import license becomes a valuable asset and it would not be surprising if the officials who issue them are not occasionally subjected to bribes.

As it seems rather anomalous that a government should impose a quota so that home buyers will pay a higher price to foreigners, especially if one object of the quota is to guard the nation's foreign exchange reserves, an elementary provision would be to limit the granting of import licenses to domestic importers.

A more desirable scheme, though, is to have the government sell the import licenses it issues. If there is competition among importers the selling price might be determined by auctioning the licenses. If there appears to be collusion among importers in bidding for licenses the quota authority may be forced to set its own price. In this last case the effect is almost the same as that of a

customs duty except that the quantity of imports is controlled directly.

Some people fondly believe that "the foreigner pays the tariff" or quota as the case may be. He probably "pays" a small part of it in that the net price to the foreign suppliers will ordinarily decline a little. But usually it will fall much less than the price to domestic buyers will rise. The geometric reason—referring to Figure 13.1—is that the combined supply schedule is nearly always flatter than the home demand schedule. The economic explanation is that the demand schedule refers only to the domestic market whereas the supply schedule reflects not only the domestic market's supply but also the excess of supply over demand in the rest of the world. A nation's market is only a fraction, and usually a small fraction, of the world market.

Of course there are some exceptions. If a nation is an important buyer of an internationally traded good, as Great Britain is of bacon, it may be able to exploit this situation to some extent. Presumably, if such a nation were to import less, the world price which it pays will be slightly lower. Hence a tariff, which reduces imports, will somewhat improve the importing nation's *terms of trade*: that is, there will be a rise in the ratio of the price it gets for its exports to the prices it pays for its imports. A number of economists, including one of the authors, has described the manner in which a country can exploit this "monopsony" power. Briefly, *other things being equal*, the importing nation should so restrict imports of the commodity in question, by means of a tariff, that the marginal money cost of the imported commodity is equated to the demand price in the home market: this will maximize the algebraic sum of customs duties, buyers' surplus, and home producers' surplus. However, other things may very well not remain the same. The exploited nation or nations may have some means of retaliation. Also, the nations that have "monopsony" influence over a few imported commodities are usually leading world powers, and it ill behooves such major powers as the United States and the United Kingdom to set a bad example by adopting beggar-my-neighbor policies.



### SOME TARIFF AND QUOTA COMPARISONS

Although the immediate incidence of tariffs and quotas can be very similar, except perhaps in providing government revenue, each provides certain advantages and disadvantages.

Quotas provide direct and certain quantitative control over imports. With a tariff no one can say in advance how much will be imported during a period such as a year. Certainty on this one point renders quotas attractive to many people although it should be realized that every other price and quantity involved remains uncertain.

Quotas are often more flexible than tariffs because the granting of import licenses is usually a matter of official discretion in regard to their timing and quantity. Tariff rates are usually legislative enactments and cannot be amended readily. Hence, if some unusual event leads to unexpectedly large imports at lower prices, these can be excluded more surely and quickly through quotas than tariffs. However, it is not always clear, except to rival home producers, why cheap imports in volume should be discouraged.

Quotas can occasion greater price fluctuations. If the quantity of imports is practically fixed by quotas, any changes in demands and supplies at home or abroad must bring about adjustments not through changing import quantities but rather through altered prices; for example, if the demand at home increases unexpectedly, and the limit on imports is unchanged, prices at home will rise much more than they would if imports were restricted indirectly through a tariff. More or less fixed quotas render demands for imports more inelastic throughout the world, and all international economic adjustments are made more difficult.

With tariffs, new importing firms and new producers abroad are not discriminated against, as they are in effect when quotas are granted in proportion to imports or output in some past "representative" period. Tariffs deter inefficient rather than efficient producers abroad. Quotas affect efficient and inefficient foreign

producers alike and tend to benefit those firms that are most persuasive when dealing with officials of the quota authority.

Most quotas provide little if any government revenue, in contrast to tariffs, although this could be remedied by selling licenses as suggested above.

In the long run the principal objection to any quota system is that as a practical matter it must include import licenses, and this further extends bureaucratic control over private commerce. Those engaged in quota restricted trade must wait upon the uncertain and sometimes capricious decisions of officials. And eventually, unless licenses are sold at their full value, it is difficult to imagine how quotas can be administered without some political preference or outright corruption.

### PROBLEMS

1. "Free trade zones and bonded warehouses have several similarities but also a number of dissimilarities." *Exemplify.*

2. "Certainty is important in economic affairs. With a quota one can predict how much will be imported. With a tariff everything is unpredictable." *Evaluate.*

3. "Tariffs provide both revenue and protection; the higher the duty rate, the more the protection, and the greater the revenue." *Evaluate.*

4. "There is only one fair way of valuing imports for customs, and that is to take the wholesale value of comparable goods within this country." *Evaluate.*

5. "It was inevitable that unilateral global quotas would in time evolve into allocated quotas and import licensing." *Explain.*

6. "The price and quantity effects of comparable tariffs and quotas—that is, ones that result in the same quantity of imports—are more alike than different." *Explain.*

7. "The bilateral quota is an open invitation to monopoly in the exporting country." *Evaluate.*

8. "We in Canada believe that there is a better approach than the detailed judicial reviews which often result in customs entries being left to vegetate for a decade or more in United States tribunals." *Discuss.*

9. "Before a duty is determined it is necessary for the customs officials to know not only the price paid by the American importer but also the domestic price of the article in the country of origin; the tariff is then computed on the basis of the importer's choice of either an average of the two or the lower of the two valuations." *Evaluate*.

10. "The opposition to customs simplification which would eliminate reference to 'foreign value' and rely on 'export value' reflects not a desire to maintain unnecessary red-tape in government but a fear of the resulting moderate reduction in our tariff levels." *Explain*.

11. "The long lapses between initial entry and final liquidation in the United States involve constant attrition of the patience as well as the pocket books of the export-import community." *Explain*.

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## CHAPTER 14

# Subsidization of Shipping

One form of protection is the subsidization of home producers. The usual object is of course to decrease imports and increase exports. Frequently the "import" or "export" is not merchandise but some service such as ocean shipping. While it is simple to prevent foreign goods being imported into a country, it is rather more difficult for a government to tell its nationals on what ships their goods and persons shall travel when abroad. A popular recourse of governments then is to subsidize national shipping and airline companies, thereby satisfying the demands of numerous special interests, usually on the grounds that this is actually a contribution to national defense. As we shall see, it is doubtful whether this last argument is altogether valid in these days of atomic warfare and "cold war" alignments.

### WHAT COUNTRIES DEPEND ON SHIPPING INCOME?

The importance of shipping, as a means of improving a nation's balance of payments, naturally differs from country to country. For some nations that have large merchant fleets and thereby earn through shipping quite large current account credits, shipping is *relatively* unimportant as a means of accumulating foreign exchange: an outstanding example in this regard is the United States, which now earns more than it pays for shipping. For some other countries, the money value of "exported" shipping services

is small but relatively most important: Norway is a familiar instance of this.

Table 14.1 shows the total shipping "exports" (credits) and "imports" (debits) of various countries in comparison with their merchandise exports and imports. Of course "shipping" in this case sometimes includes payments and receipts arising from airline and even rail operations: but the largest part of these amounts (over 90 per cent) are occasioned by sea transport. Port disbursements, a considerable item, are also included. Unfortunately more precise information is lacking save for a very few countries. As might be expected, in relative terms and on a net basis, countries like Norway, Greece, Egypt, Italy, and the United Kingdom far outrank the United States, even though in fact the latter now has the largest merchant marine in the world. This enormous legacy of World War II is partly in commission and partly in the reserve fleet. (Over 300 ships of this reserve fleet are being used to store grain acquired by the federal government incidental to its farm price support operations.)

It is not surprising that certain nations, although operating large fleets, should still depend to a considerable extent upon foreign flag ships to move their imports and exports. Most of Canada's foreign trade moves in foreign bottoms, for example. If strict proportionality were the rule, each nation would, of course, carry half its combined overseas exports and imports. However, the same principle of comparative advantage that enables the United States to out-compete the rest of the world in operating airlines also permits other nations to out-compete the United States when it comes to constructing and operating merchant ships.

If one surveys those nations having rather advanced economies but little cultivated land, relative to population, one sees that they all take to the sea to supplement their livelihood, either through fisheries or shipping. Japan, the Netherlands, Greece, Norway, and Italy are all cases in point. Great Britain and Germany afford less obvious examples. But when one considers the United States, where labor productivity is extremely high, there are many other jobs than building and operating ships that appear more worth-

TABLE 14.1

COMPARATIVE IMPORTANCE OF SHIPPING TO MERCHANDISE EXPORTS AND IMPORTS  
FOR SELECTED COUNTRIES, 1954<sup>a</sup>  
(money values in millions)

Country	Monetary Unit	Credits			Debits		
		Transportation	Merchandise	Per Cent	Transportation	Merchandise	Per Cent
Denmark	D. Kroner	1,225	6,771	19	1,025	7,520	14
Egypt	Eg. pounds	38	144	26	7	156	4
France	U. S. dollars	137	2,545	5	241	2,724	9
Germany, West	U. S. dollars	368	5,228	7	382	4,248	9
Greece	U. S. dollars	31	161	19	36	294	12
Italy	U. S. dollars	286	1,581	18	300	2,194	13
Japan	U. S. dollars	90	1,594	6	256	2,034	13
Netherlands	Guilders	400 <sup>c</sup>	8,831	—	—	9,697	—
Norway	N. Kroner	3,711	4,303	86	2,191	6,921	32
Panama <sup>b</sup>	Balboas	7	40	18	12	73	16
Sweden	S. Kroner	405 <sup>c</sup>	8,218	—	—	9,208	—
United Kingdom	Pounds St.	388	2,815	14	256	3,007	8
United States	U. S. dollars	1,222	12,691	10	1,001	10,300	10

<sup>a</sup> Includes other forms of transportation and port disbursements.

<sup>b</sup> 1953.

<sup>c</sup> Net of debits.

SOURCE. International Monetary Fund, *Balance of Payments Year Book*, Vol. 6.

while. No one doubts the technical ability of the United States to construct fine ships—their operation by United States crews may be another matter—but a great many people do question whether this is an economic use of American labor.

It is therefore not surprising if some foreign countries, including many of our military allies, resent the large subsidies appropriated by Congress for ship construction and operation by United States companies. It is rather as though Texas decided to subsidize the construction and operation of motor buses by Texas firms, paying up to one-half the cost of manufacture. Michigan would certainly have something to say about this. Of course the governor of Texas would excuse this policy on the ground that travel by buses is essential to survival in that state. However, Michigan might argue that even if Texas needs buses, it does not have to make them

too; and some of the interstate bus lines would probably offer to contract for the needed service anyway.

However, before considering some of these policy issues further, let us survey this tremendous international industry of ocean shipping.

### WORLD SHIPPING STATISTICS

Ninety-nine per cent of transocean freight tonnage still moves by water, although on some routes—e.g., across the North Atlantic—the airlines are now taking up to half the passenger traffic. This freight is not of one kind, and so it requires different kinds of ships. There are dry cargo ships that operate everywhere, refrigerated ships bringing meat and butter from Australasia and Argentina to Europe, tankers bringing petroleum and products from the Middle East to Europe and from Venezuela to the United States, and ships that carry Labrador iron ore to the United States. (Some of these ships—notably tankers and ore carriers—are private carriers owned by large integrated companies.) There are a number of dry cargo ships carrying a dozen or so passengers but following freight routes. Last but not least are the passenger liners. Table 14.2 indicates the relative number and tonnage of some of these different kinds of ships for the world as a whole.

Today most of these ships follow definite routes according to a schedule. The days of the “tramp,” picking up cargoes here and there as opportunities arise, are almost over. However, the major routes still spread out from the English Channel, across to North America, through the Mediterranean and Suez, through the Panama Canal to South America and to the Cape of Good Hope. Sooner or later most ocean-going ships pass at least once through the western approaches to the British Isles, that historic submarine “battlefield” of two world wars.

Each of these ships is documented under the laws of some particular country and flies its flag. Table 14.2 shows for the leading maritime powers only the number and tonnage of ocean-going ships by type and flag. About two thousand of the ships nominally under the American flag are laid up in the reserve fleet. Inciden-

TABLE 14.2

**MERCHANT FLEETS OF THE MAJOR MARITIME POWERS<sup>a</sup>**  
(tonnages in thousands)

Country	Total		Passenger and Cargo		Passenger and Refrigerated		Freighters		Freighters Refrigerated		Bulk Carriers		Tankers and Whalers	
	No.	G. Tons	No.	G. Tons	No.	G. Tons	No.	G. Tons	No.	G. Tons	No.	G. Tons	No.	G. Tons
Denmark	316	1,512	24	75	2	3	227	894	10	27	6	14	47	499
France	583	3,635	83	811	2	32	313	1,382	27	107	40	127	118	1,176
Germany, West	591	2,166	20	138	—	—	498	1,655	14	39	24	90	35	244
Great Britain	2,531	17,482	181	2,022	42	713	1,398	7,965	134	1,223	226	561	550	4,998
Greece	201	1,187	17	89	—	—	162	928	—	—	4	11	18	159
Italy	585	3,700	74	670	4	33	351	1,718	9	32	20	74	127	1,173
Japan	610	3,337	24	117	—	—	501	2,464	5	31	7	41	73	684
Liberia	429	4,005	8	59	—	—	236	1,540	2	9	15	122	168	2,275
Netherlands	520	3,211	94	699	—	—	315	1,707	—	—	1	3	110	802
Norway	1,082	6,862	30	126	3	10	600	2,389	18	54	21	142	410	4,141
Panama	510	3,883	15	139	—	—	264	1,473	7	17	25	108	199	2,146
Spain	288	1,077	42	220	—	—	197	618	1	6	14	40	34	193
Sweden	574	2,575	33	211	—	—	399	1,180	17	64	42	293	83	827
U.S.S.R.	596	1,794	70	357	—	—	438	1,109	9	36	16	29	63	263
United States	3,324	25,358	248	2,288	2	14	2,553	18,139	49	300	45	328	427	4,289
World	14,952	90,955	1,238	9,288	61	854	9,958	50,743	341	2,102	625	2,359	2,729	25,609

<sup>a</sup> Limited to ocean-going ships of 1,000 gross tons and over.

SOURCE: Federal Maritime Board and Maritime Administration, *Annual Report, 1955*, Washington, D. C.



tally, Switzerland has a small merchant marine in foreign trade, but one that has to operate from foreign ports.

Any analysis of world shipping must take into account the age distribution of the tonnage still afloat. This is because ship construction in the past has been a matter of starts and stops. Each of the two world wars has been a period of feverish construction. The immediate postwar periods have also been marked by construction, partly to replace wartime losses, but also to build modern merchant ships that can be operated far more profitably than the emergency "Liberty" and "Victory" designs. Subsequently, shipbuilding has tended to decline, except that tanker construction has increased, stimulated by the Suez crisis of 1956. Table 14.3 gives the distribution of ocean dry cargo tonnage by period of launching, it underscores both the replacement problem that will probably arise in the late sixties and the preponderance of wartime steamships in the United States merchant marine.

TABLE 14.3  
AGE DISTRIBUTION OF DRY CARGO SHIPS STILL REGISTERED,  
UNITED STATES AND GLOBAL

Year of Launching	United States Registered Dry Cargo Ships				Global (including United States) Dry Cargo Ships					
	Number		Gross Tonnage <sup>a</sup>		Number		Gross Tonnage <sup>a</sup>		Per- centage Gross Tonnag	
	Motor	Steam	Motor	Steam	Motor	Steam	Motor	Steam		
1951 thru 1955 <sup>b</sup>	18	30	24	414	2,176	666	7,270	3,952	8.8	
1946 " 1950	109	539	444	4,155	1,427	1,612	4,406	8,777	20.9	
1941 " 1945	52	2,008	220	14,504	828	3,686	2,615	23,952	42.3	
1936 " 1940	2	10	4	95	572	347	1,897	1,427	5.3	
1931 " 1935	2	21	3	233	217	294	887	1,046	3.0	
1926 " 1930	0	9	0	54	269	524	1,266	1,935	5.1	
1921 and 1925	1	22	0	126	140	1,115	434	3,494	6.2	
1920 & before <sup>c</sup>	0	19	0	72	93	1,177	134	3,500	8.4	
Totals	184	2,658	695	19,653	5,722	9,421	18,909	48,083	100.0	

<sup>a</sup> Gross tonnage in thousands.

<sup>b</sup> Estimated for 1953 through 1955.

<sup>c</sup> Approximate for 1920 and before.

SOURCE. *Bremen Year Book of World Shipping*.

Operating ships is only part of world shipping. The construction of ships is an industry in itself. And it need not follow that the countries that operate ships are those that do or should construct them. For example, Norway and Greece have many ships in foreign trade but only a few of the smallest were constructed in home yards. The nations that specialize in peacetime shipbuilding, as Table 14.4 indicates, are Great Britain, Sweden, the United States and the Netherlands; actually, West Germany and Japan are important ship-building countries too.

This concentration of shipbuilding in a few countries is largely, of course, the outcome of lower costs. Shipbuilding costs are largely a function of wage rates, the laid-down costs of steel plate and structural steel, and the proximity of a marine engine industry that can make low bids. Construction on the ways is largely an assembly job. There is no need for the engines, propellers, steel plate, electrical equipment, fittings and furniture to come from the same country: it is not impossible for a ship laid down in Italy to have British turbines, German engine-room gauges, and United States radio equipment. However, because assembly line methods of construction are not possible in peacetime, yard labor is an important cost element. Thus low wage rates, coupled with the existence of an advanced marine engineering industry, explain the concentration of shipbuilding in countries like Germany and the Netherlands. Put another way, construction costs are low in countries where the resources used in shipbuilding have poor alternative employments.

Actual cost comparisons among nations are hard to obtain, partly because of the subsidization policies of the United States. British shipbuilders are not going to reveal their costs if they know that the United States Maritime Commission will counter any differential between American and British construction costs with a subsidy. However, Table 14.5 gives some cost differences for tanker construction, a most important type of shipbuilding today; this table also shows the inflation in costs that has occurred since 1950.

Operating costs are another matter again. Two kinds of ship operating costs should be distinguished. First, there is one set of

TABLE 14.4

## DELIVERIES OF NEW MERCHANT SHIPS 1954-55

Registry for Which Built	Total	Country in Which Built							
		United States		United Kingdom		Sweden		Netherlands	
		Number	Gross Tons	Number	Gross Tons	Number	Gross Tons	Number	Gross Tons
Total	594	19	308	163	1,373	55	535	48	332
United States	12	12	165						
United Kingdom	119			106	889			3	47
Sweden	24					20	209		
Netherlands	29							24	180
Norway	90			23	226	28	274	5	35
Denmark	20								
France	37								
Italy	19					1	16	6	23
Japan	31								
Germany, West	70								
All others	143	7	143	34	258	6	36	10	47
								1	12

NOTE: Seagoing steam and motorships of 1,000 gross tons and over by ship type, country in which built, and for whom built; excludes ships built for operation on the Great Lakes Inland Waterways; Armed Forces; and special types such as tugs, ferries and cable ships; tonnage in thousands.

SOURCE: United States, Federal Maritime Board and Maritime Administration, *Annual Report, 1955*, Washington, D. C.

TABLE 14.5  
COMPARISON OF TANKER BUILDING PRICES

<i>Building Country</i>	<i>Delivery Date</i>	<i>Load Capacity</i>	<i>Contract Speed (knots)</i>	<i>Total Delivery Cost (£1,000)</i>	<i>Dollar Cost (per deadweight Ton<sup>b</sup>)</i>
Sweden	1948	15.9	14	475	84
Great Britain	1949	15.5	13	500	90
Sweden	1951	16.4	15	625	107
Great Britain	1951	16.6	14.5	825	140
Great Britain	1952	15.5	13	700	126
West Germany	1952	16.5	13	910	154
Great Britain	1952	15.5	14	800	144
Norway	1953	18.5	15	910	154
West Germany	1954	16.5	15	920	150
Sweden	1955	16.3	15	800 <sup>a</sup>	—
Norway	1956	16.5	15	920 <sup>a</sup>	—

<sup>a</sup> Final delivery price unknown; order price substituted.

<sup>b</sup> Converted from sterling at \$2.80 per pound.

SOURCE: "Fairplay," London; quoted in the *Bremen Year Book of World Shipping*.

expenses that have very little to do with the "nationality" of the vessel: examples are fuel, most provisions, stevedoring, marine insurance, harbor dues, branch offices, and agents' compensation. Second, there is a set of expenses that do depend on "nationality": examples are the wages and subsistence of crews, repair and maintenance (usually done at a home yard), depreciation and interest expense (a function of acquisition costs). The "richer" countries also tend to provide better quarters for the crews that man their ships. For these and other reasons there is no doubt that operating costs vary considerably among nations. Just what these differences are in dollars and cents it is difficult to say because, due to countervailing subsidies paid by the United States Maritime Commission, foreign operators are loath to reveal their operating costs in too great detail.

Incidentally, it is traditional for the shipowners of every country to complain about the lower wages and poorer subsistence accorded foreign seamen. King James I of England, who was King James VI of Scotland also, finally brought about a Union of the two

Kingdoms in 1607. However, the English Parliament would never exempt Scottish shipowners from the English Navigation Laws. It was alleged that while Scottish seamen could subsist on oysters they caught themselves, English seamen demanded and got roast beef and ale. All this has a familiar ring.

### AMERICAN SHIPPING AND ITS SUPPORTERS

A century ago, and for sound economic reasons, the United States had one of the leading merchant marines in the world. This expansion started during the Napoleonic Wars, in which the United States was a neutral, and it continued until the Civil War. During this period 90 per cent of American foreign commerce was carried in American vessels.

In those days the Atlantic seaboard states had a comparative advantage in shipbuilding and voyaging. New England was well endowed with timber for ship construction, but not with fertile land for agriculture, and many early immigrants were trained shipwrights. The whaling and fisheries created a market for New England ships and crews. Later the California gold rush placed a premium on speedy passages around the Horn. The Yankee Clippers, with their hard-driving skippers, were rivaled only by the British ships in the China tea trade. The coming of steel and steam, replacing wood and canvas, changed everything. The steel and engineering industries of the United States did not develop in New England, or even on the Atlantic seaboard. In Britain and Germany though, shipbuilding and heavy industry were located close together.

Other forces, perhaps more powerful, were also at work. After the Civil War the character of the American economy altered rapidly as the frontier moved west, production became fairly standardized and mechanized by European standards, and industry developed around the Great Lakes. The effect of all this was considerably to increase the productivity and wages of American labor and to raise them above those of any other country. Moreover, as shipbuilding involves a considerable amount of labor and does not

lend itself to standardization, this inevitably placed American shipbuilders at a competitive disadvantage. Many American shipping lines found themselves unable to surmount the twin handicaps of having to buy and maintain more expensive domestic-built ships and to satisfy the higher wages and more expensive shipboard conditions demanded by American seamen.

Consequently, by 1914, the tonnage of the United States merchant marine had declined by two-thirds from its peak of 2.5 million tons in 1860. During the First World War the dependence of the United States on foreign shipping for the carriage of its foreign trade caused losses and great inconvenience. Memories of this are still alive despite the changing character of wars and alliances.

World War I created an American shipbuilding industry, of a sort, almost overnight. Thousands of Liberty ships were built to replace U-boat sinkings, to carry war material to the Allies, and to deploy American armed forces abroad. When the war was over many of these ships were sold for almost nothing, many went into reserve fleets where they soon deteriorated beyond any hope of economical repair, and a few continued to operate.

Almost the same pattern of events occurred during World War II. Over two thousand ships, many of them Victory ships, were built. Many of the construction yards had had no previous experience in shipbuilding. Officers and crews had also to be trained to man these vessels. This remarkable feat was accomplished in a few years.

However, paradoxical though it may seem, neither of these two world wars provided an economic basis for either an American shipbuilding or ship-operating industry. The wartime construction was designed for easy and rapid building. The ships that were built do not have efficient hulls and their engines develop only moderate power. Speeds that are satisfactory for convoy work may not be competitive in peacetime. Many of the yards that built the wartime ships do not have the engineering ability—either in terms of personnel or equipment—to produce a variety of designs for the varied needs of different shipping lines. Men who will staff

ships in wartime prefer other peacetime employments. While the United States has produced many famous seamen the truth is that ships and the sea have not caught the imagination of Americans of the past few generations. They are more likely to look to the sky—and quite properly too—where the United States has an important comparative advantage.

People are interested in money as well as in glamor. There have always been a number of special shipping interests importuning Congress and the Administration for government protection and subsidies. Some of these lobbies are extremely powerful. They include representatives of the leading American ship-operating companies and of the major shipbuilding firms. Also extremely important are the pressures exerted by the unions that represent the seamen, engineers, stewards, and the various specialists who go to sea. Organized labor in the shipbuilding trades makes common cause with the major shipbuilding companies. And officials of local governments and chambers of commerce in the shipping centers add their voices to the chorus for help.

The song these special interests sing has many tunes but the common theme is "national defense." It is argued that the United States must have a large merchant marine in being to guarantee the arrival of necessary imports in wartime, the export of war material to allies, and of course the overseas movement of our own armed services with their equipment. As a means to this end it is claimed that United States shipbuilders and operators must be paid a subsidy, sufficient to cover the difference between their costs and those of foreign firms, and that 50 per cent of all American foreign trade should be carried in American ships. Congress has gone a long way towards acceding to these demands.

### **FEDERAL MARITIME POLICY**

During the past four decades the Federal Government has become increasingly involved, as a regulator and as an interested party, in the affairs of American shipbuilding and operating companies. Intervention has taken three main forms: shipbuilding

subsidies, operating subsidies, and navigation laws supplemented by cargo preference. Today it is no longer possible briefly to describe all these and other programs, although most of them stem from the Merchant Marine Acts of 1920, 1928, and 1936, as amended.

The Merchant Marine Act of 1936 asserted that the national defense and the development of foreign and domestic commerce required the United States to have a merchant marine (a) sufficient to carry all its domestic water-borne commerce and a substantial portion of its foreign commerce; (b) capable of serving as a naval and military auxiliary in time of war; (c) owned and operated by citizens so far as practicable; (d) composed of the best-equipped, safest, and most suitable vessels, constructed in the United States; and (e) manned with a trained and efficient citizen crew. This policy statement still reflects Congressional opinion.

The principal instrumentalities of federal policy are now the Federal Maritime Board and the Maritime Administration, both in the Department of Commerce, annually dispensing a sum equal to about one dollar per person in the United States. The justification of all these activities has been national defense. The result has also been to provide more wages and profits for domestic workers and corporations.

#### **SHIPBUILDING SUBSIDIES**

The Shipping Act of 1916 established a Board to construct, lease, and operate vessels for use in the foreign trade, and to mitigate the effect of wartime diversions of foreign shipping: under this program the merchant marine grew to 2,500 vessels, totaling eight million gross tons. After the war the Merchant Marine Act of 1920 provided a revolving construction fund of 125 million dollars. In 1928 this fund was doubled. Nevertheless, competitive forces were reducing the American merchant marine, until by 1936 it comprised about 400 vessels totaling a little over two million gross tons.

The Merchant Marine Act of 1936—passed in a depression



to be operated must be "essential," and the operator must have the experience and ability to provide adequate service. The Board is authorized to enter into a subsidy contract with the applicant for a period not to exceed 20 years. The subsidy is to cover the amounts by which the contractor's expenses for insurance, maintenance, repairs (not covered by insurance), wages and subsistence of officers and crews, and for other items, are substantially in excess of those incurred by foreign flag competitors. In the event that the contractor earns over 10 per cent on the capital necessarily employed in the subsidized operations, he shall reimburse the United States for half of these excessive earnings on capital, but this reimbursement shall not exceed the operating differential subsidy received by him. In most years a small portion of these subsidies is in fact "recaptured" from some subsidized operations.

These operating subsidies are sometimes granted on condition that the contractor replace certain of his vessels with new American-built ones. Thus in 1956 the Federal Maritime Board entered into a 20-year operating differential subsidy contract with an American shipping line, serving South American and Pacific Coast ports, on condition that it replaced its two major passenger-cargo liners and 24 other vessels over this period. The cost of the replacement program was estimated at 286 million dollars, and, if the past is a guide, federal taxpayers will foot about 40 per cent of the bill. One of the justifications cited by the Chairman of the Board was that this program would provide 25,000 man-years of shipyard employment. The number of United States shipyard workers is sometimes set at 100,000, although only 70,000 of these are regularly employed. Most of these are engaged on naval construction anyway.

One of the parties most interested in the Federal maritime program is the active seafaring union membership that mans these subsidized vessels. Under Title III of the Act, the Board sets minimum wage scales, manning tables, and working conditions, for all officers and crews employed on all types of vessels receiving an operating subsidy. And under Title VI of the Act the Board pays for the extra costs it occasions in these respects under Title III. It

is true that wages of officers and crews are only about 20 per cent of direct operating expense, but labor costs are exactly one of the expenses which differ for American and foreign flag ships, so that almost every extra dollar for officers' and crews' wages comes from the taxpayer. Also, the subsistence and quarters of crews on modern American ships are luxurious in comparison with those on foreign ships: these differences are all subsidized in one form or another.

In 1955 about one-half of the American dry cargo merchant marine was receiving operating subsidies. A few years earlier the profits before taxes of subsidized shipping companies were about double the net operating differential subsidy received. There are no reasons for supposing that this was an especially atypical year.

#### **NAVIGATION ACTS AND CARGO PREFERENCES**

In the seventeenth century the British and Dutch sought to protect their merchant shipping through navigation laws. The United States and other nations are imitating these practices in the twentieth century. For example, since 1817, Congress has prohibited all save United States-documented vessels from engaging in the coastwise, intercoastal, and noncontiguous waters trade of the United States, or in the fisheries of the United States. Vessels cannot be documented for these uses unless both the owner is American and the ship in question is United States-built. In some cases this embargo on foreign companies does little to help United States shipping companies. Today, for example, passengers cannot travel by sea from one Pacific port to another, as domestic shipping lines no longer provide this service and foreign companies are not permitted to, although some of them operate ships along the coast from Panama to Canada. Hence the real beneficiaries, in some cases, are other competing forms of domestic transportation. In other instances though, these cabotage restrictions remove a great deal of intercoastal freight from foreign carriage.

Cargo preference is another way in which Congress has indirectly subsidized American labor and capital employed in building and operating ships. For many years the special interests involved have

been demanding that 50 per cent of all United States foreign trade should be carried by United States ships. Fifty per cent is a nice round number and it has a spurious implication of equity about it. The Chairman of the Federal Maritime Board has stated that "if American ships carried 50 per cent of American cargoes many of their troubles would be overcome." This is probably true, as American flag ships are now carrying about one-third of all American foreign trade, but that does not make it desirable. As a matter of fact, most industries would do considerably better if their business could be increased by one-half through government regulation.

Anyway, Congress has heard the call of the shipbuilding and ship-operating companies, and of the 100,000-odd and 80,000-odd men that they sometimes employ respectively, and granted cargo preferences on government financed shipments. In 1948 a temporary measure was enacted requiring that 50 per cent of all tonnage moving abroad that had been procured by the United States, or for foreign governments with United States funds, should be carried by American flag ships if reasonable and practicable. Between 1948 and 1954 the Economic Cooperation Administration and its successor "aid" agencies paid almost one-half billion dollars for shipping services and somewhat less than half of this went to American ship operators. However, the State Department and the agencies providing aid were more interested in moving goods abroad promptly and economically than they were in protecting special interests at home. They did not always plan their shipments in quite the mercantile spirit that was considered desirable and proper in other quarters. So in 1954 Congress made cargo preference permanent by amending the Merchant Marine Act of 1936 to provide that 50 per cent of all United States government financed cargoes should be carried by American ships if available at fair and reasonable rates.

Although the tonnage of government financed freight that moves abroad is subject to fluctuation, it has tended to be quite considerable in some past years. For example, in 1952, foreign movements by sea amounted to a total of slightly over 40 million long tons, of which 18 million long tons comprised Department of Defense and

Mutual Security Agency shipments moving on privately operated vessels. In addition, the United States Military Sea Transport Service operates passenger and cargo ships for government account.

A relatively minor act of protection, but one that has recently caused complaints from abroad, is the requirement, under the Merchant Marine Act of 1920, that all mails of the United States carried on vessels shall, if practicable, be shipped on American-built vessels documented under the laws of the United States. It is sometimes a nice point whether or not this is practicable. In 1955 Norway complained that mail from the United States was seriously delayed because the postal authorities in New York were not utilizing foreign ships, even when faster, and having earlier sailing dates than the next departing United States-built and documented vessel.

### NATIONAL DEFENSE OR JUST MERCANTILISM?

The more one explores the ramifications of United States shipping policy, and examines statements by the federal agencies involved, the more one begins to wonder. Does this program contribute primarily to national defense or to the support of a bureaucracy that, from patriotic but perhaps mistaken motives, is in practice coddling a number of special interests? What are the real needs of national defense as regards merchant shipping in a war of the *future*?

Perhaps we should first distinguish between peripheral wars on a minor scale—such as those in Korea and Indo-China—and a major World War III between the Soviet Union and the United States with their allies.

In a peripheral war our own military forces have to be deployed and material must be delivered to co-belligerents. It is extremely important to get personnel and supplies to the area of hostilities as soon as possible, and some personnel can always be airlifted most or all of the way across the Pacific or Atlantic as the case may be. Large tonnages of material probably cannot be unloaded at destination until port facilities are expanded. Even when these have be-

come available, possibly four to six months later, the required tonnages would not place an unbearable strain on available world shipping.

A major Soviet-American war might take various forms. It is barely possible that the belligerent powers might refrain from strategic atomic bombing of cities. In this event the main hostilities might be on the European continent between ground and air units employing tactical atomic weapons. The situation would be extremely fluid, and it is most doubtful that a ground war from fixed positions would develop. Within a few months the Soviet ground forces would either be decisively repulsed or have occupied the continent. The war would then be over or the routed power at that time would resort to strategic bombing.

It is more probable, though, that long-range atomic bombing of cities would initiate the war, or at least occur concurrently with ground action in Europe. In this case the Soviet Union and the United States would probably each lose a hundred major cities within a few weeks. The Americans that survived, whether or not the war was "won," would be busy keeping alive. They would not be carrying out elaborate plans for economic mobilization.

What, in each of these two eventualities, would be the special contribution of the *American* merchant marine?

In the event of an all-out atomic war, including city bombing with thermonuclear weapons, it is hard to imagine what essential shipping requirements would arise that could not be met by available shipping, most of it foreign. Our ability to produce or move goods and people—whether civilian or military—to the seaports, and load them there, would seem to be very limited after such attacks on our industry, population, and transport. Our need of certain foreign imports might be considerable, but our ability to unload and distribute them could be slight. Water, food, clothing, heat, and shelter will be the major needs. Most of these must be domestically provided.

The only *remote* wartime eventuality that might place serious demands on all available merchant marines is that of a Soviet-American war that excluded strategic bombing and resulted in a

*prolonged* ground war on the European continent. This would also become a submarine war and a battle of sea communications. In some respects it would be the sort of war, plus tactical atomic weapons, that the world has already experienced twice.

In this unlikely event it is the number of available ships that will matter and not the number of merchant ships that happen to fly the Stars and Stripes. All NATO and allied shipping not captured in port by Soviet forces will become available for the common cause. All neutral shipping that leaves port will also become available to allied use. After all, with the exception of the Baltic, Black, and Caspian Seas, the United States Navy, Royal Navy, and other allied military units will together control the surface of all the oceans and seas. The United States and its allies control passage through the Panama Canal, through the Straits of Gibraltar, around South Africa, and into the Western Approaches. They control all important sources of bunker fuel for shipping and all the larger dry docks. So long as the United States and its allies exercise sea power, all the shipping that is on the high seas at the onset of hostilities, or subsequently sails upon them, will do so at allied bidding and in the service of the common war effort.

In order to be doubly secure, however, the United States might wish to have rather more shipping under more immediate control. In this case the Federal Government has several alternatives that are less expensive than the one now pursued. American shipping lines might be given operating subsidies but be permitted and even encouraged to obtain their vessels from the cheapest source—which normally would be abroad. Or the Federal Maritime Board, under amended legislation, might acquire vessels from abroad and lease them to foreign operators, on the condition that the United States Government could cancel the charter without notice and that the senior officers on each such vessel be United States citizens.

If the real needs of national defense are considered, in terms of probable future wars, many present Federal maritime policies seem inappropriate. Today the Federal Maritime Board determines what are "essential" routes that must be sailed by American ships so that cargoes can be moved on them in wartime. Peacetime trade routes

do not, however, necessarily have the same pattern as wartime trade routes. Actually, much of this thinking stems from World War I experiences, when belligerent nations diverted their shipping during the three years *preceding* the entry of the United States into the war. In World War III the United States will probably be a belligerent from the first hour.

Even in an unbombed home economy it would take a considerable time to reactivate the present reserve fleets—having first emptied the grain out of some of them—and it is questionable whether the probability of their eventual use justifies any expensive modernization.

It is also well to remember that airlift is sometimes an alternative to sea carriage. Ships built today can have a useful life of from 20 to 30 years. During this time aircraft capable of carrying substantial payloads over long distances will undoubtedly come into operation. Aircraft specifically designed for cargo airlift are flying now. They can transport crucial military supplies, such as aircraft and tank parts, much more promptly than can ships, thereby raising Air Force and Army equipment in-commission rates in overseas theaters of operations. Emergency troop movements will certainly go by air. The total cost of the present Federal maritime program would go a long way towards increasing such an airlift capability. This reallocation of Federal funds might prove economical in a military sense, although such a matter is difficult to determine. However, it does seem clear that in cargo aircraft the United States has a comparative international advantage, whereas the numerous subsidy requests from shipping interests have made it abundantly clear that this country suffers a comparative disadvantage when it comes to merchant shipping.

### CONCLUDING COMMENT

For centuries the shipping policies of nations have been a cause of controversy and a source of discord. The earliest manifestations of the crudest kinds of mercantilism were the Navigation Laws of the seventeenth century. Many of these are still enforced by the

United States. Also, like some other governments, the United States subsidizes such shipping as is in foreign competition, but to an extent that is without parallel abroad. It is not hard to identify the special interests that are being benefited by this program. Of course these interests can well argue that, if numerous farm products are to be price-supported by the government, why should not ship construction and ship operation also be. However, the justification usually advanced is that of national defense. A little thinking about possible wars of the future suggests, however, that shipping requirements may never equal those of former world wars, that if they do prove to be considerable other than American flag shipping will be available, and that in any case an expenditure of similar Federal sums for other purposes might contribute more to national security.

### PROBLEMS

1. "The only way the United States can be sure of moving its foreign commerce is to have an adequate merchant marine of American built, American owned, and American operated shipping." *Evaluate.*

2. "It is all very well to follow the dictates of comparative advantage as regards trade in wheat, motorcars, or silk handkerchiefs: but shipping is an altogether different matter, and economics has nothing to do with it." *Evaluate.*

3. "If each and every nation carried 50 per cent of its foreign trade, no nation would need to fear for the carriage of its foreign trade and all nations would be treated uniformly and hence equitably." *Evaluate.*

4. "It is an anomaly that the United States, which has probably built more ships since 1916 than any other nation, should still be largely dependent upon foreign flag shipping." *Explain.*

5. "In wartime it is the *available* shipping that counts and no one cares under what country's laws a usable vessel was or is registered." *Explain.*





## CHAPTER 15

# Pleas for Protection

No discussion of trade policy can continue long without one or more hoary old arguments for protection being advanced. Several of these familiar pleas—some more logically respectable than others—are examined in this chapter. As each instance of protection usually benefits one special group of producers and workers, at the public's expense, an attempt is often made to suggest that protection, at least in *this* case, really advances some larger cause, such as national defense.

### KEEP THE GOODS AND MONEY

One of the oldest and simplest arguments for protection—and still occasionally resurrected—is the old mercantilist notion that if one buys imports from abroad money is lost to the economy, whereas if one buys locally the goods *and* the money are kept at home. This argument could as well be applied to a town or to a single state—in which case some of its more absurd consequences become obvious—but it is usually advanced as a reason for restricting imports into a country. This mercantilist attitude confuses means and ends: money cannot be eaten or worn but can be used to obtain, say, food and clothing. If money had a utility of its own all economic problems could be solved by inflation.

However there is a more sophisticated and modern version of this idea that deserves more scrutiny. This revised version emphasizes that payment for imports constitutes a leakage just as savings con-

stitute a leakage, in the circulation of payments within a country. Hence, it is alleged, protection will reduce the leakage occasioned by imports, thus raising the level at which the national money income will be in equilibrium. (The economic theory underlying the argument has already been given in Chapter 5 and is presented in greater detail in Appendix A.)

The main issue upon which this case rests is one of fact. No one doubts that increased protection will reduce imports, and hence very probably the payments made for them, but will exports long remain unreduced if foreigners make fewer sales to us? Actually, the money paid for imports is normally not "lost" in these days of inconvertible currencies, but in time is used by foreigners in the country of its issue. What, for the most part, can Frenchmen, say, do with dollars, earned from sales to the United States, except to spend them or sell them to someone who will spend them, in the United States? If protection reduces exports (an injection) as much as it reduces imports (a leakage) there will be no tendency for the national *money* income to rise. Moreover, if it is economic welfare we are considering, it is real income and not money income that matters. And the normal tendency of protection is, of course, to raise prices in the home country.

### INCREASED OUTPUT AND EMPLOYMENT

It is often stated that the imposition of a tariff or quota will increase economic activity at home.

If by this it is meant that the protected industry will experience increased economic activity, assuming that home production is possible, the statement is probably correct. Of course, in some cases further output may be physically very difficult. And unless there is an increase in aggregate demand for goods and services within the country there will be a decrease in output and employment in one or more other trades. The export lines, for instance, will probably suffer a decrease in their sales.

But the increased output argument is often pushed further. It is alleged that if there is no unused plant capacity in the newly

protected industry, there will be an additional increase in economic activity as new plants are constructed and equipment installed. This certainly might happen although in fact the trades that usually shout the loudest for protection are those that are losing sales to imports and so have excessive capacity. There is also an economic waste if there is merely a transfer of home demand to the protected industry for some of the fixed investment in *other* trades may now become redundant before it has depreciated through use. In any case this capital acceleration aspect of the case is a once-for-all affair.

It is still further alleged that there will normally be an increase in aggregate demand and employment because the new plant and equipment for the protected industry will normally be financed out of additional bank credits. This, however, is something that may or may not happen. The new fixed investments may very well be financed by banks but not necessarily out of *extra* bank credits. An inflation of the effective money supply may only raise prices if there is no appreciable slack in the economy.

The trouble with this whole argument is that it considers the protected industry only and assumes that its increase in output and employment and bank borrowings is added to an economy that remains unchanged in all its other sectors. Even if this were true temporarily it probably would not be so over a longer period. Some of the nation's comparative advantage will have been sacrificed, and this must be offset against any increase in national employment that may occur and endure.

Certainly this argument cannot be pushed to an extreme without becoming ridiculous. Complete self-sufficiency would undoubtedly maximize employment. But would not our longer hours of work yield us a poorer real income?

### EXCLUDE FOREIGN DEPRESSIONS

It is sometimes asserted that depressions are "imported" from other nations, as in fact they sometimes are, and that increased self-sufficiency would reduce susceptibility to the trade cycles of other foreign countries. This argument rather gratuitously assumes

that foreign countries are less capable of preventing economic fluctuations than the home country. It also tends to overlook the advantages of "importing" full employment. And, incidentally, this argument for protection hardly applies to the larger nations.

If a country earns its foreign exchange by the export of a few products, and especially if these are sent primarily to one country abroad, it would be idle to deny that the economic activity of the former country is very dependent upon that in the latter. Thus a recession in the United States and Great Britain will soon result in reduced exports by Malaya, Australia, Bolivia, Venezuela, Chile and other raw material producing countries. When these countries cannot export, they cannot import after a while, and on short notice they are unable to produce reasonable substitutes for most imports at home. Moreover, in bad times the prices of raw materials fall more than do those of manufactures so that the terms of trade move against these countries of specialized exports.

A real question, of course, is whether the cost of increased self-sufficiency is worth the reduced fluctuations in income and consumption. Some of the raw material producing countries can never hope to manufacture, say, automobiles and heavy machinery although they could probably make bicycles and textiles, for example, at not too high a cost. Moreover, the raw material producing countries are not self-sufficient even as regards basic commodities. Australia has wool and meat but little oil. Guatemala has coffee and bananas but few exploited minerals. Moreover, if these countries became more self-sufficient, the usefulness of large specialized investments in mining, petroleum production, and agriculture would be lost.

Perhaps these governments could better solve their problem, not by renouncing the advantages of comparative advantage, but by the enforced partial, and occasional, saving of foreign exchange earnings on exports. In good times a certain percentage of export receipts could be placed in a blocked account to the credit of the exporter. In bad times these could be released to him gradually and he could use or sell them as they became available. Fluctuations in the country's *imports*, but not exports, would be reduced. Unfor-

unately, this scheme requires a government wise enough to distinguish between good and bad export years and strong enough temporarily to withhold earnings from exporters.

### REAR INFANT INDUSTRIES

The infant-industry argument is at least as old as Alexander Hamilton and Frederick List. These two publicists, concerned with the United States and Germany respectively, wished their own countries to develop industrially. This was exceedingly difficult under conditions of free trade because Great Britain already possessed entrenched manufactures with established trade connections throughout the world. Both Hamilton and List lamented the slow progress their domestic industries were making in the face of such stiff rivalry. They wished to ensure the economic destiny of their countries by giving infant industries a measure of protection until they could stand on their own feet. It was held that this "nursing period" was necessary in order that entrepreneurs could gain experience, a sufficiency of skilled technicians could be trained, and subsidiary supplying trades could be built up. Both Hamilton and List disclaimed any sympathy for weakling industries, which would be unable to survive even in maturity without the help of a tariff.

Essentially, this argument is an assertion of fact and should be treated accordingly. The real question is whether or not there are some industries that (1) are justifiable and self-financing in the long run, (2) inevitably sustain losses during their early years, *and* (3) would never be established in the absence of protection. No industry can qualify for "infant" status unless it meets all three tests. A practical problem in executing this policy is to recognize infant industries as such before they receive protection.

But how are legislators to recognize infant industries in advance? Current losses can be verified, but it is largely conjectural whether or not an unprofitable industry will eventually emerge from the red. This uncertainty is dangerous because all new trades that suffer losses will claim protection as "infants," regardless of any possibility of attaining satisfactory adulthood. Finally, how is one to know that

the prospect of initial losses will deter capitalists from establishing a new industry? Most successful trades commence with losses, as is illustrated by the automobile industry, but private funds are usually forthcoming to carry the business through hard times.

We are now approaching the crux of the matter. There are a great many possible new lines of production that, after early losses, are expected to earn profits. At what point do the later profits outweigh the early losses? In the case of private investment this is largely controlled by the interest rate. If the rate is high, as is often the case in new countries, later profits will be very heavily discounted and will not compensate for the more immediate losses. In such a case private investors will not provide the necessary funds, and we must ask ourselves if the industry's establishment is truly worth-while. If our answer is yes, we are in effect saying that the going anticipated interest rate used for discounting is higher than it should be, and that the economy is paying less attention to the future than it should. Theoretically, the government of the day should decide how much lower the proper interest rate ought to be, or it will not know how far it can go in approving new industries that are unsound and unjustifiable by all ordinary financial tests.

If a government believes a prospective industry is economically worthwhile, but this industry seems unable to obtain the necessary capital funds from private sources, the government should invest in the new trade openly and directly or grant it a subsidy per unit of output. The customary alternative, however, is to compel consumers to pay higher prices by means of a tariff; thus, in effect, buyers are forced to donate the needed funds. In the event that the early financial storms are successfully weathered, it would seem only fair that these consumers should later be rewarded by passing on to them potential profits in the form of exceptionally low prices. In other words, a new industry which becomes established through indirect consumer subsidization is thereafter obligated to the public interest, and its prices should perhaps be regulated accordingly. This never happens.

The infant-industry apology for tariffs is one of the few pro-

tectionist arguments to which free traders pay grudging lip service. The practical difficulty is to detect ultimately healthy "infants" in advance. Little political perspicacity is required to realize that an infant industry that has become established behind a protective tariff has also become a powerful vested interest capable of sustaining legislative lobbies. Protected industries naturally cling to their tariff privileges whether or not they can exist without them. History is replete with examples of infants that secured protection but reveals almost none that subsequently grew up to admitted manhood. The infant-industry argument has been used as a Trojan horse too often.

The situation of backward countries, with dense populations and no experience of capitalism, is very different and requires another sort of analysis. These countries aspire to nothing less than the immediate modernization of their primitive economies. Their growing populations are a constant menace and protection or free trade is one of the less important policy issues facing their governments. (See Part VI.)

### SAFEGUARD DOMESTIC WAGES

There is an enormous difference in wage structures among the nations of the world. The lowest wages paid in the United States are certainly higher than the lowest wages paid in any other country. Congress has enacted a minimum wage of \$1.00 in interstate commerce. This is more than most hired labor in China or India earns in a day. It is not surprising, then, that the advocates of protection have seized upon these wage contrasts to frighten American workers with the spectre of rival coolie labor.

First, we must recognize that wage rates and labor costs are not synonymous. Let us suppose that the common labor rate is \$1.00 an hour in the United States and 20¢ an hour in Italy. Let us further suppose that it takes 8 man-hours to make Product A in the United States and 40 man-hours to make the same commodity in Italy. In this case the labor cost is \$8.00 per unit of output in both countries.





How is it possible for common labor to vary so in efficiency from one country to another? One explanation may be that each worker is combined differently with land and capital. Thus, the agricultural labor in the United States has far more acres of wheat land to work with than does his Italian counterpart; likewise the American factory worker will be better equipped with automatic lathes and the like. This is perhaps the most potent cause.

Another explanation, though, is that the workers in some countries may be more efficient because of superior health, education, or acquired skills. A great deal of the native labor in colonial areas suffers from malnutrition, disease, and parasites, so that it is physically weak and mentally dull. In some backward countries much of the labor force may lack sufficient education to read instructions or carry through simple calculations. A primitive mode of living also precludes mechanical ability: for example, a Rumanian peasant may have trouble running a simple farm machine which would be child's play to an American reared with gadgets and appliances of all sorts.

It is unrealistic, however, to suppose that American labor is five times as productive as Italian labor in all lines of production. An Italian woman handmaking lace will on the average be the equal of an American girl. In other occupations the American may be more than five times as productive as the Italian. It is the *average* difference in labor efficiency that is the chief cause of disparities in the common wage rate.

The resultant variation in labor cost often determines, especially where transportation costs are small and associated production costs are about the same in both countries, which country will specialize in what lines of production.

The arithmetic of this thesis is set forth in Table 15.1. In terms of labor wages alone the cost of making Product A is the same in both countries; Products B and D can be made more cheaply in Italy; and Products C and E have a lower labor cost per unit of output in the United States. Other things equal, Italy will produce B and D, the United States will make C and E, and both countries will turn out A. It is noteworthy that this geographic division

TABLE 15.1

Product	United States (\$1.00 hr.)		Italy (20¢ hr.)	
	No. Man-Hrs.	Labor Cost	No. Man-Hrs.	Labor Cost
A	8.0	\$8.00	40	\$8.00
B	1.5	1.50	4	.80
C	2.5	2.50	15	3.00
D	.1	.10	0.3	.06
E	.5	.50	3	.60

of labor is based on *comparative* rather than *absolute* superiority in labor productivity. Physically, American labor is more efficient in the making of all five commodities, but especially in the making of C and E.

High wages in a country are evidence of its competitive strength. High wages should be the subject of self-gratification. There need be no fear that they will suddenly be snatched away by some foreigner, because they were never bestowed by the foreigner in the first place. High wages depend on personal efficiency, available capital, and bountiful natural resources. These determinants rest on domestic foundations that cannot be affected externally.

One qualification is necessary. Sometimes foreigners will have an undue advantage because *our* costs are *artificially* high or *theirs* are *artificially* low. The prices of intermediate goods used in production at home may be too high because of trade-association activities. Wages in some domestic employments may be above the equilibrium rate because of labor union pressure. Foreign governments sometimes subsidize their export trades or keep labor costs unduly low. Then, our domestic economy probably will be overly vulnerable to foreign competition, and there may be some measure of underemployment as a result of imports.

It would be quite impossible for protection to eliminate general unemployment because so little unemployment is attributable to foreign competition. Most unemployment is caused by (1) job changing, (2) seasonal and cyclical fluctuations, and (3) personal inadequacies. Protection will not shorten the interval of unemploy-

ment which often exists when a man changes his job because he is dissatisfied or wishes to move to another part of the country. Protection cannot neutralize the weather and holidays that are responsible for much of the existing seasonality; and it is very unlikely that protection will prove a substantial remedy for the business cycle. Protection will not cure people who cannot hold jobs because they are physically incapacitated, temperamentally unsuited, or mentally inadequate.

The important thing for the laborers of any nation is that they be allowed to work in the occupations for which they and their environment are best fitted. A doctor would resent a government decree that forced him to do all his own laboratory work. Similarly, organized labor should not allow itself to be sidetracked by protective tariffs into lines of work in which its superiority is markedly less. This can only mean a reduction in real wages in the end.

### **PROTECT DOMESTIC PROGRAMS**

Most national governments intervene in the economies of their countries in numerous ways. Support prices for agricultural commodities, minimum wage rates for labor, and deficit spending programs designed to promote higher incomes are common examples. If the government intends to keep the domestic price of wheat above the competitive world price, wheat imports must be excluded or taxed. If increased minimum wage rates drastically increase the competition which certain domestic industries would face from imported goods, the government may accord these industries protection rather than witness their elimination. If the fiscal program of the national government includes deficit financing and domestic money incomes, and prices are rising, certain balance of payments problems may arise. Under these various circumstances, should imports be restricted?

When a government supports prices, it usually does so to win the political support of domestic producers; it does not wish to extend the taxpayers' bounty to foreign producers. Thus the practical alternative is usually between domestic support prices with

protection, or no domestic supports. In very many cases, support prices for particular domestic products are as uneconomic as tariffs, for both tend to distort the proper pattern of resource use; hence the free trader might argue that one of the advantages of a system of unrestricted imports is that it would render domestic support schemes impractical.

It is less evident whether or not high wage floors should be supplemented by protection against imports. If, in terms of man-hours of labor, a country has a comparative advantage in, say, making steel, it would be unfortunate if legal wage minima induced large steel imports and contracted domestic production. In this case, perhaps the mistake of arbitrarily raising wages too high might best be mitigated through protection, so that the nation can continue to make those products in which it has a comparative advantage. Domestic producers, vouchsafed semi-monopoly powers by quotas or tariffs, will then be able to compel domestic buyers to subsidize the highly paid workers of the industry so the possibility of imposing import restrictions encourages governments to tinker with domestic prices and wages for political reasons, without thought to their effect upon resource use.

Advocates of deficit financing have often complained that the government investment multiplier will be reduced through the leakage occasioned by increased purchases of foreign goods; they have suggested that import restrictions are therefore necessary supplements to certain fiscal policies. Logically, foreign investments as well as merchandise and service imports should be controlled in this case. What is needed is exchange control, and as full employment is approached, the exchange control must be used on many fronts so as to insulate the domestic economy. In order to have full employment, an economy may have to accept a certain amount of misemployment.

Government intervention in economic affairs must often be supplemented by import restrictions if the outcome, economically desirable or not, is to be what the administration of the day desires. Government officials prefer to conduct their socio-economic experiments under controlled conditions. They wish to reduce the num-

ber of variables which they must consider and are especially hostile to elements beyond their jurisdiction. Unrestricted foreign trade places on their activities a competitive check that they wish to eliminate. One of the costs of domestic economic programs is often a loss of the benefits of national specialization and comparative advantage.

### EQUALIZE COSTS OF PRODUCTION

A once-popular program, and one that especially appeals to sporting instincts, is the adjustment of tariffs to neutralize any "unfair" cost advantages possessed by foreigners, after which, may the best firm win.

Those who usually place great trust in the beneficial effects of commercial competition are often illogically attracted to this policy. But surely, if competition realizes worthwhile economies within a country, it ought to possess even wider potentialities for good when practiced on an international scale. Competition does not lose its virtues when a boundary happens to separate rival producers.

There are many practical difficulties to a *flexible tariff* as here proposed. How is a government agency to ascertain foreign costs of production when it has no subpoena powers abroad? Costs of production are constantly changing, and depend in part on volume of sales, and hence on exports and domestic tariffs. Different countries and different firms have different costs of production. Is there to be a special rate for each country or firm?

The basic objection to this argument is that the economic problem cannot intelligently be likened to a handicap race. It makes no sense to bind one arm of the most efficient producers. This is no way to solve the universal problem of how to satisfy a few of our insatiable desires with the least possible exertion.

If the rationale of this scheme has any real logic, it would seem that countries that have higher costs on an average should be granted a subsidy, in order that they might no longer labor under a disadvantage; surprisingly enough, this is never suggested!

Some free trade economists have carelessly supposed that such a neutralizing use of tariffs, by eliminating all cost advantages,

would bring about a cessation of international trade. This might be true in the long run. In reality, though, goods move among nations according to short-run considerations, and there will always be a number of foreign firms whose prime costs will be more than covered by the export price even after deductions are made for customs duties.

### BARGAIN WITH TARIFFS AND QUOTAS

It is sometimes contended, especially by nations that have little or no protection, that lack of protection cramps the government in attempting to induce other nations to lower their tariffs. It used to be said in Great Britain, for example, before the innovation of systematic protection in the early 1930's, that the United Kingdom government had no bargaining weapon with which to pry open foreign doors closed against British exports. People who advance this argument usually pay lip service to the ideal of freer trade by suggesting that temporary protection is the most practical maneuver to effect it.

It seems a little circuitous and dangerous to seek freer trade by first restricting it more rigorously. Vested interests are likely to make sure that what was intended by some as temporary protection will prove permanent in the end. Moreover, in treaty negotiation the promise not to increase a tariff rate is often as sharp a bargaining weapon as an agreed reduction. Half of the undertakings contained in some of the trade treaties negotiated by the United States Department of State are *bindings* rather than cuts.

Sometimes protection is urged in retaliation against foreign tariffs and quotas. This is tantamount to cutting off one's nose to spite one's face. Protection normally injures the nation that enacts it as well as the foreign economy.

This is the fundamental point so often missed by the public and by government officials. Reducing one's own tariffs admittedly benefits the foreign country to some extent, but it also gives advantages to the domestic economy. The true interests of different nations, except in certain monopoly cases, are not in conflict.

Whatever clash of interests does occur is between domestic producers and users of the protected goods. Protection should logically give rise to civil war rather than international conflict.

### NATIONAL DEFENSE

The "trump card" of the protectionist, at least in many countries and for a surprisingly wide range of products, is supposedly that national defense requires the exclusion of imports that are "destroying" some "war industry." This assertion often silences discussion, partly because most economists know very little about military strategy and requirements, but also because it appears unpatriotic to urge freer trade at the risk of the nation's security. However, it is often helpful to ask for what war with what allies and with what weapons must the home industry be protected?

Most national defense arguments for protection mistakenly assume that the home country will fight alone, without imports from allies or neutrals, and that therefore the proper goal is national self-sufficiency in wartime. These arguments usually cite experiences in World War II, which was in many ways a long war of attrition, and during which almost all industry and transportation were mobilized in support of the war effort. Protectionists today still seem to assume that a major war between the American and Soviet blocs with both sides making heavy atomic strikes within the first week, would resemble World War II. This seems most unreasonable and does not appear to be the official view of the United States Government.

Nevertheless, we are told by protectionists in the United States today that such diverse activities as petroleum production, merchant shipbuilding and operation, watchmaking, rope making, and wool growing are all essential to national defense and should be protected in peacetime against foreign sources of supply. However, one might think it better to conserve petroleum reserves within the United States by making greater use of foreign crude in peacetime. The real needs of the United States for shipping, and how perhaps they can best be satisfied, have been discussed in

the preceding chapter; it is probably wise *not* to subsidize the construction and operation of merchant ships by United States companies. The kinds of accuracies and skills required for watchmaking are largely available or surpassed in certain sections of today's electronic industry. A little stockpiling of Manila rope may well see us through the duration of an atomic war. While it is nice to think of "our boys" going off to war in uniforms of American grown wool, the truth is that much cheaper wool can be had from Australia; a little stockpiling will give protection against lack of sea transport, and the next war may not last long enough to mobilize, train, equip, transport, and use a large army.

Even if one assumes that World War III will degenerate into a long war of attrition, after the first atomic strikes have devastated all the major cities, it is not clear that we should now restrict the imports of things we might need in war so as to develop domestic sources of supply in peacetime. What is the use of encouraging the development of industries in the United States if their plants and workers are located in or near major cities that may well be obliterated by atomic weapons? If there are difficult industrial operations, requiring very specialized machines and skills to make an output that might become critical in World War III, it would be best to subsidize these directly and require that their production be located far from likely atomic targets. In the case of raw materials, most of which can be stored inexpensively, stockpiling appears to be the most economic solution so long as stocks are accumulated from the cheapest sources. However, the national stockpile program has at times come closer to being a political hand-out than a national defense measure, with Congressmen suggesting riders to appropriation bills that would require the stocking of home produced commodities only.

If there is another major war, lasting several years, the United States will have access to many allies and neutrals that will be anxious to supply needed raw materials and some of which can supply the shipping to transport them. It is the purpose of sea power to ensure that this commerce has a high probability of arrival and this is one of the main justifications of the United States



Navy. Also, increasingly in the future, goods having a high military value per unit weight will be airlifted, and one of the functions of the United States Air Force is to make or protect such flights.

It seems more probable, however, that World War III—if and when it comes—will largely be fought with atomic weapons and with existing forces. In this case it will be utterly different from either of the two world wars in which the United States has participated. The mobilization of the economy will not be completed if only because what remains of it will be fully engaged in recuperation. The surviving remnants of the industrial labor force will be occupied in keeping alive.

Accordingly, if World War III is likely to be of short duration, the economic burden of preparation will be borne in peacetime, when the seaways and airways are open. The cost of establishing and maintaining offensive and defensive military forces, with their atomic weapons, is very high; moreover, this is a cost which may have to be borne year after year. It is therefore essential that the United States and its allies undertake this preparation in as economical a manner as possible. This means making the most of the opportunities that exist for national specialization. Fortunately, especially within NATO, no one nation possesses a comparative advantage in providing more than a fraction of the military requirements. The United States has a comparative advantage in the making of atomic weapons and strategic bombers. But Germany has a comparative advantage in forming ground divisions and the British perhaps in the operation of anti-submarine units. In fact, if there were no uncertainties among allies, it might be more economical to have the United States provide weapons and aircraft for British and German forces to maintain and fly. This would of course be an extreme position. But it is an encouraging sign that the NATO ground forces will primarily consist of Franco-German troops, using a Belgian automatic rifle, supported by United States tactical aircraft carrying atomic weapons, and flying from French and British airfields where the ground personnel are mostly nationals.

If national defense considerations have any significance for trade policy, it is surely that national specialization can contribute greatly towards reducing the cost of preparation for a major atomic war. National specialization is of course a synonym for free trade. Patriots who are sincerely interested in obtaining the maximum preparedness from the annual national defense budgets should resist suggestions by interested parties that protection and greater self-sufficiency—except perhaps in a very few instances that are seldom mentioned—will do anything but subtract from the defense effort.

### CONCLUDING COMMENTS

The above list of protectionist pleas might impress some people by its very length. But the list is long because each argument is based on some special and extenuating circumstance, and economic life is highly varied. Moreover, there is an intellectual satisfaction to be derived from discovering possible exceptions. By way of contrast, a general principle can often be stated in a single sentence. So it is with the case for free trade, but such brevity does not gainsay its weight or truth.

Most of these arguments for protection are incompatible. Some of them apply only to tariffs and are quite inapplicable to other forms of protection. They often have objectives which are at variance with one another. Occasionally, the arguments are based on conflicting assumptions. In short, they cannot all be simultaneously valid: whenever some are acceptable, others must be rejected. And an examination will show that a number of these pleas for protection can hardly apply to the United States.

Occasionally a sound policy can be rendered harmful through political misdirection. For example, the infant-industry suggestion may often merit initial acceptance, but in the end it will be exploited by selfish interests to the detriment of the nation. A good idea can often be put to bad use. It has been aptly said:

. . . protection might procure economic advantage in certain cases, if there was a Government wise enough to discriminate those cases,

and strong enough to confine itself to them; but this condition is very unlikely to be filled.<sup>1</sup>

### PROBLEMS

1. "There is a crude version and a more sophisticated version of the 'Keep the Goods and Money' argument for protection." *Explain.*

2. "The United States needed wool for uniforms in the last war and we'll need it again: if we grew all our own wool requirements our nation would be more secure." *Evaluate.*

3. "Many of the arguments for protection at different times and in different countries hardly apply to the United States in the middle of the twentieth century." *Exemplify.*

4. "When I was in India I saw men working for a dime a day; it would be madness to permit imports from India of anything we can grow or make in this country." *Evaluate.*

5. "We cannot very well have a price support program for farm products simultaneously with unrestricted imports of the same commodities." *Explain.*

6. "The NATO forces are supported by a network of 'common infra-structure,' the unlovely term which describes fixed installations such as headquarters, airfields, pipelines, and port facilities. This infra-structure should be re-enforced by member policies which minimize economic interdependence of the group." *Evaluate.*

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<sup>1</sup> Ascribed to Edgeworth by Haberler, *Theory of International Trade*, page ix.

## CHAPTER 16

# Immigration

No study of international trade can afford to ignore international population movements. Some of the leading nations of the world—including the United States—owe their present position in part to past immigration. Also, as we saw in Chapter 4, transfers of labor among countries are a partial substitute for merchandise trade in the long run. The concept of an optimum size population for a nation is one that needs examination too. Finally, we must consider whether widespread emigration, from some of the densely populated Asiatic countries to those that are more sparsely settled, would contribute to economic welfare by relieving population pressure.

### TEMPORARY LABOR MIGRATION

There is a certain amount of international worker migration in frontier regions, but of a temporary sort, with the worker's permanent home remaining unchanged.

Sometimes the international aspect of the arrangement is very incidental, as in the case of people who work in Detroit (Michigan) but live across the river in Windsor (Ontario). Similarly, many Italians who live near the frontier, work during the week in the Tecino Canton of Switzerland and return home at week-ends to their families. These instances of international labor migration are little more than the result of a frontier happening to lie between work and home.

Rather more significant cases are those where workers, with or without their families, migrate seasonally to another country for work. Before World War II many Poles used to migrate to Germany, Belgium, and France each year to help with the harvest. Many Mexican field workers migrate annually to Texas, Arizona, and California, and a few "wetbacks" come to stay longer. There is some regular seasonal migration from Italy to France, mostly in the building trades and agriculture.

Of a less regular nature, but still with no permanent settlement intended, is the organized recruitment of Italian miners for work in Belgium and the unorganized movement of British West Indians to England. This last is a postwar development, facilitated by relatively easy and inexpensive air coach travel from the Caribbean to London, but also stimulated of course by the rise in British pay scales and the increasing job "choosiness" of British workers. For the first time in the history of Great Britain a "color" problem is developing in certain regions of South London.

Temporary labor migration has primarily an economic motivation. Young men and women, often leaving their families, will work for a while in another country where jobs are available and wages seem extravagant in comparison. Sometimes the object is to save enough money to marry when they return to their native land, but often it is to remit excess earnings to the family at home. In these cases, unlike those of permanent immigration, the migrant has little intention or desire to stay too long in an alien land among strangers. He or she remains emotionally loyal to the homeland.

Temporary labor migration tends to stir up very mixed emotions in the country of employment. The general effect of such migration is of course to lower wages and the marginal productivity of labor in the "receiving" economy. Consequently there is usually opposition from labor organizations and support from employer groups.

Some countries though, such as Great Britain, have more than adequate employment. There are many jobs, and particularly the more unpleasant ones, that are going abegging. Theoretically, in the long run, there is of course a solution. Either the wages paid

for such work should be raised enough to attract workers, or the fact should be accepted that certain unpleasant jobs are being eliminated by the improved position of the working classes. In practice though, in the short run, it is more likely that these jobs will remain unfilled in the absence of temporary foreign workers. It is then not so obvious that foreign workers tend to reduce the marginal productivity of labor in the country of immigration, if they are restricted to the sorts of jobs that local labor will not take. Coal mining, especially in Great Britain where it is nationalized, provides a good example. Production there is declining per man, the mining labor force is not being replaced, and the country is using foreign exchange to import coal. The British government would like to recruit foreign labor to mine more coal, add to the gross national product, and save foreign exchange. So far the opposition of the coal miners' unions has prevented immigration for this work.

In the United States the migration of Mexican field workers illustrates this same point. Would the enormous and valuable output of the Imperial Valley exist—which in turn contributes to employment in transportation and commerce—if the only available workers were white Americans? Under the circumstances the United States and California governments, encouraged of course by the farmers, co-operate with the Mexican government in the annual recruitment and return of these migrant workers.

Temporary labor migration, from one country to another, is likely to be opposed by the government of the "receiving" country, however, if the foreign workers will compete directly with local labor, and especially when the latter is organized. Thus the British government would probably refuse work permits to foreign metal workers whereas they might grant some to foreign waiters. For more special employments, as in motion pictures, there may be an unofficial policy of reciprocity. Thus the British government may grant, say, as many work permits to American actors as the United States government grants necessary visas to British actors. Except in special circumstances, as when a home industry appears to depend wholly or in part on foreign labor, the temporary foreign

worker is less welcome than the permanent immigrant. There will probably always be some resentment toward foreigners who, unwilling to become naturalized and establish new loyalties, stay in a country temporarily to obtain higher wages. However, it should be realized that it is his homeland that raises and educates the migrant, and may have to support him in his old age, so there is little economic justification for resentment in the country of temporary employment.

### EMIGRATION OF ITALIANS: A CASE STUDY

For over half a century Italy has been an important source of temporary emigration to other European countries and of permanent emigration across the Atlantic and to Africa. Over the past century the population density, now 450 per square miles of agricultural and forest area, has just about doubled. With a crude annual birth rate of 17.6 per 1,000, and a death rate of 9.0 per 1,000, the natural population growth is currently a little less than 1 per cent a year. While Italy thus has an increasing population, it has very little capital and few energy resources. Moreover, the land available for agriculture is limited by the mountainous terrain and in the South by the destructive effect of flash floods following heavy rainfall. The dense population and limited opportunities for useful employment, especially in the South, make foreign employment attractive to young Italians. The question is what country can they go to.

The natural increase of the Italian population is now a little in excess of 400,000 a year and the net annual movement to other countries is somewhat under 200,000 a year. Hence, a crude estimate would be that approximately one-half of the natural increase is being currently relieved through emigration. Most of the permanent emigration is not to Europe but overseas to the "New World," the most important countries of destination being Argentina, the United States, and Canada in that order, although migration to Venezuela and Australia is also significant. Temporary emi-

gration, mostly to Switzerland and France and indeed often of no longer duration than the work week, has also resulted in recent years in an increase in the total number of Italians earning their livelihood outside their country.

Table 16.1 provides data on some of these points. The indicated net emigration of 190 per 1,000 in 1954 is probably a slight overstatement because in every year there are some native Italians, domiciled abroad, who return to the "old country" to live out their days. The large number of Italian residents moving to and from Switzerland and France is mostly due to tourists and to those who live in Italy but work on the other side of the frontier during the work-week.

TABLE 16.1  
EXTERNAL MIGRATION OF ITALIAN RESIDENTS IN 1954  
(to nearest thousand)

Country of Destination	Departures of Italian Residents				Arrivals of Italian Residents	Net Emigration of Italian Residents
	First Departure		Subsequent Departures	Total		
	For Work and "called forward"*	Other Motives				
Penelux	4	5	8	17	9	8
France	22	82	213	317	294	23
Switzerland	31	99	388	518	482	26
United Kingdom	3	2	2	7	3	3
Argentina	32	0	3	35	8	27
Australia	16	0	1	17	2	15
Canada	22	0	2	24	1	22
United States	24	2	4	30	5	24
Venezuela	18	1	4	23	10	13
Europe	60	223	739	1,022	947	75
Mediterranean						
Basin	1	3	7	11	13	-3
Transoceanic	128	4	17	149	32	117
Total	189	230	763	1,182	992	189

\* "Called forward" ("atto di chiamata") usually means going to join relatives.

SOURCE: *Compendio Statistico Italiano*, 1955.



The more traditional kinds of emigrants are those going abroad for the first time to take a job or because they have been sent for ("called forward") by relatives who have pioneered before them. In 1954 these accounted for about 189,000 emigrés. More information on them is given in Table 16.2. As might be expected, a majority of those who leave for work are men, while a majority of those sent for are women and girls. It is worth noting that the United States and Canada are nowadays a destination, not so much for those seeking work, as for those joining relatives.

TABLE 16.2

ANALYSIS OF FIRST DEPARTURES OF ITALIAN RESIDENTS  
EMIGRATING FOR WORK OR "CALLED FORWARD"<sup>a</sup> IN 1954  
(to nearest thousand)

	<i>For Work</i>	<i>Called Forward</i>
United States and Canada	7	39
Other Transoceanic	20	62
Europe and Mediterranean Basin	51	10
Male	63	48
Female	15	63
Total	78	111

<sup>a</sup> Usually means going to join relatives.

SOURCE: *Compendio Statistico Italiano*, 1955.

The Italian government assists emigration, whether permanent or temporary, both as a means of reducing unemployment and increasing the inward flow of emigrant remittances. It negotiates with a number of foreign governments, and essentially it recruits Italian workers for the jobs it has been able to develop with industries abroad. In this way about 78,000 workers—rather less than one-half of the net emigration—were placed abroad in 1954 by the Ministry of Labor and Social Security. Table 16.3 provides some details. Most of the workers going to Belgium went into the mines, those to France were mostly employed in the building and metal trades or in seasonal agriculture (mostly sugar beets), and those to England went for work in brick kilns, restaurants, or domestic

service. The United States government has at present no special arrangements to facilitate migration, such as Argentina, Canada, and Australia have, with the Italian government.

TABLE 16.3  
GOVERNMENT ASSISTED EMIGRATION FROM ITALY IN 1954

Belgium	2,849
France	9,276*
England	2,432
Argentina	28,914
Brazil	11,042
Canada	2,073
Venezuela	4,784
Australia	616
Other	638
Total	62,624

\* Excludes 15,173 seasonal workers.

SOURCE: *General Report on the Economic Situation in Italy in 1954*, Rome, Ministry of the Budget, 1955.

The differences in wage rates obtainable at home and abroad are very considerable and are widely known in Italy. Thus, to take the case of a young woman working as a domestic servant and living in, she might earn \$15 a month in Italy; in Britain she would probably receive \$45; and in the United States \$150. Comparisons of earnings for men who live out would tend to be less extreme but still different, between say Italy and the United States, by a factor of from three to five times.

All in all, it is not to be wondered at if the waiting rooms of foreign Consulates in Italy are usually full of people and sometimes scenes of tragedy.

### PERMANENT IMMIGRATION AND ECONOMIC DEVELOPMENT

One of the outstanding phenomena of the past one hundred years has been the settlement and development of such countries as Canada, Argentina, Australia, and the United States by immigrants and their descendants. During this period 50 million people left Europe for the new lands of opportunity and in one year

a million people immigrated to the United States alone. At the same time the nations of Western Europe were exporting capital for the development of these regions of recent settlement. Great Britain, for example, exported from 3 to 5 per cent of its national income annually, especially to Canada, Argentina, and Australia, supplying equipment and material for railroads, public utilities, and industry. The new fixed capital needed labor and the immigrants occasioned a demand for more capital in turn. Without externally supplied labor and capital these new countries could never have been developed at the rate they were.

This massive exodus of people from Europe to the new lands across the seas tended to fluctuate in accordance with political disturbances and failing food supplies. The great Irish migration was hastened by failures of the potato crop, and the marked preference for immigration to the United States over Canada was often prompted by dislike of the British. (The reason so many Irish went to Boston was that, being several hundred miles closer to Ireland, the fare was slightly less than to New York or Philadelphia.) The collapse of a number of revolutionary movements on the European continent in 1848 led to further emigration. Throughout the latter half of the nineteenth century the United States continued to attract the dissatisfied poor of Europe, mostly from Germany and Scandinavia at first, and then increasingly from Italy, Poland, and Greece. Emigrants from Great Britain, largely from Scotland, went primarily to the present Dominions of Canada, Australia, New Zealand, and South Africa, where they could continue to live under the Union Jack. The main wave of British immigration was to Canada during the decades prior to World War I. The Dutch tended to go to their own overseas possessions and, until the Boer War, to South Africa. The French, of all the leading European nationalities, contributed little to transoceanic migration.

The motives of these migrants were mixed. Some sought a republican form of government, a land with no established ruling class, and so came to the United States. Many left to escape political persecution or religious discrimination. But a great many left because they were economically desperate and willing to risk

the little they had to come to a new country where labor was at a premium and land was often available for the taking. The spacious, fertile, empty plains of Canada, the United States, and Argentina were a mighty lure for the land-hungry peasants of the Old World.

Some people have suggested that if, for generation after generation, a new country is peopled by immigrants, its people will, in time, become somewhat different from those of the older countries. After all, people who migrate to a new land tend to be those who are unwilling to accept continued deprivations, who are prepared to make a drastic change and run risks to improve their lot, and who have the mental stamina to plan and persevere in what to them is certainly a major undertaking. Such people tend to be daring rather than cautious, experimental rather than conservative, pragmatic rather than traditional. On the other hand, the people of the older European countries are the descendants of those who were insufficiently dissatisfied or enterprising to make a change. In contrasting the vigor of economic life in, say, the United States and Great Britain today, it is interesting to speculate on whether the descendants of immigrants are psychologically distinguishable in some average sense from the descendants of those who remained behind.

Shortly after World War I the annual flow of migrants across the Atlantic was checked by restrictive immigration laws in the United States and also to some extent in Canada. The economic depression of the thirties further increased the unwillingness of the newer countries to accept unemployed immigrants. However, since the termination of World War II, there has been some renewal of emigration from Europe, but largely under government auspices. Australia and Canada have taken the lead in recruiting emigrants from Great Britain, Holland, and Italy. In 1956 the one-millionth immigrant since the war entered Australia; a little less than half this immigration has come from Great Britain. The United States, with ten times the population, today accepts about the same number of immigrants as does Canada. Table 16.4 provides some further details for a few selected countries in 1954.

The great international migration of the past one hundred years

TABLE 16.4

EMIGRATION AND IMMIGRATION OF SELECTED COUNTRIES, 1954  
(in thousands)

Country	Emigration			Immigration			Net Immigration
	Nationals	Aliens	Total	Nationals	Aliens	Total	
Argentina	*	*	19	*	*	44	25
Australia	*	*	35	*	*	104	69
Belgium <sup>a</sup>	11	28	39	6	46	52	13
Canada	*	*	*	*	154	154	154
Denmark	16	3	20	13	5	18	-2
Germany	47	0	48	1	11	11	-37
India	10	*	10	2	*	2	-8
Italy	251	*	251	107	*	107	-144
Japan	9	24	33	39	23	62	29
Netherlands	55	4	59	22	4	26	-33
New Zealand	6	0	6	21	3	24	18
Union of South Africa	*	*	11	*	*	16	5
United States <sup>b</sup>	2	27	29	*	*	184	155
United Kingdom <sup>a</sup>	136	13	149	82	10	92	-57

<sup>a</sup> 1952.

<sup>b</sup> 1953.

\* Apparently unavailable.

SOURCE: International Labor Organization, *Year Book of Labor Statistics*, 1955.

may now be over, but it is important to realize that the immigrant, as he walks down the gangway, is still usually an asset to the country that receives him. The immigration officials have made sure that he is healthy in mind and body, that he has some education, and that he has no police record: in fact, because of these selective controls, he may well be a better specimen than many who have arrived not from abroad but through birth. All the expense of his rearing has been borne by another economy, and he usually arrives with many productive years ahead of him. Although not yet a citizen he will pay the same taxes. If for a while he remits part of his earnings to relatives in the "old country"—sometimes a cause for complaint by mercantile patriots—it should be remembered that these will finance exports and subtract no more goods and services from the national product available to others than would be the case if the immigrant's family were living with

him. The immigrant is often prepared to perform necessary but nasty work that local labor refuses to do. In a country such as Australia, where there is an acute shortage of labor, the advent of the immigrant permits the joint employment of more land and capital.

Another, but important, consideration is whether his culture and language make it easy or difficult for him to become a *socially* useful member of his new community and homeland.

### UNITED STATES IMMIGRATION POLICY

Really significant control of immigration by the United States government dates from the years following World War I. Since then the main broad aims of United States immigration policy have been (1) to exclude non-white Asiatics and Africans; (2) to maintain the ethnic composition of the United States at earlier dates such as 1890 and later 1920; and (3) to limit total annual immigration. In recent years increased opportunities have been provided for the immigration of close relatives and persons expected to make a substantial positive contribution to the country. The United States has never discriminated against aliens on religious grounds.

Federal control of immigration began in 1882 when Chinese were excluded. Convicts, prostitutes, and mental defectives have long been excluded also. In 1917 persons likely to become a public charge were excluded and a literacy test—nominally to test education and intelligence—was introduced. In 1921, as transportation again became available following the war, the first immigration law incorporating quotas by national origin was passed. This was a most significant step as hitherto there had been no attempt to control the total number or ethnic origin of immigrants from Europe. Thus World War I marked the end of an immigration era.

During the inter-war period the Immigration and Naturalization Act of 1924 was the main embodiment of United States policy on these subjects. Persons wishing to come to the United States to work or stay had to obtain an immigration visa from a United

States Consul in their country. The applicant had to satisfy the consular officials that he did not fall within one of the excluded classes, and normally he would provide medical and police certificates, and various proofs that he would not become a public charge. If the applicant was a national of Canada, Mexico, or one of the independent American republics, he could then proceed to the United States. Otherwise, being a "quota national," he would have to wait his turn, sometimes a matter of years. A separate quota was determined for each quota area or country, in the same proportions as the estimated ethnic composition of the United States in 1890, later changed to 1920. In practice the Italian quota would be filled for many years ahead while the British quota would be more than half empty. For many years the Act was administered by the Secretary of Labor, partly with a view to protecting wages and employment in the United States. During the depression years it became increasingly hard for those without some independent means to obtain immigration visas. Even by 1938, net alien immigration was only about 50,000, including non-quota nationals.

During World War II the administration of the Act was transferred to the Attorney General, the emphasis then being on control of subversion and espionage. An Alien Registration Act was passed requiring unnaturalized immigrants to keep the Department of Justice informed of their address. This requirement is still in force.

The years following World War II were marked by a welter of conflicting views regarding desirable changes in immigration policy. In some quarters there was a widespread feeling that the United States should make at least a gesture to uprooted humanity by accepting more displaced persons. Certain ranchers and industrialists were complaining that certain labor skills, supplied by former immigrants, were dying out and could only be replaced by further immigration. Congress was under pressure from constituents to amend the statute to facilitate the entry of foreign wives and children of United States service men. There was fairly general agreement also that, if the United States was to continue a policy of severely limiting total immigration from quota areas,

at least a greater effort should be made to give preference to people with unusual and needed skills and training. Finally, "cold war" fears of "communists" led to demands that the immigration laws be tightened. From all this emerged the Immigration and Nationality Act of 1952 (the so-called McCarran-Walter Act) which was repassed over the President's veto.

The Act excludes a long list of "undesirables," including feeble-minded, insane, epileptics, illiterates, recently-serving convicts, polygamists, anarchists, those advocating totalitarian government or the overthrow of the United States government, and others guilty of moral turpitude.

The Act further provides that immigrants intending to take employment may be excluded if the Secretary of Labor certifies that there are enough workers available at the place of the immigrant's destination or if entry of the immigrant would adversely affect the wages and working conditions of those similarly employed within the country.

The new enumeration of non-quota immigrants includes the children or spouse of a United States citizen—primarily service men—returning from a temporary absence abroad.

The principal quotas actually established under the McCarran-Walter Act of 1952 are given in Table 16.5. Not shown are 57 nominal quotas of 100 each for minor countries, territories, and principalities, including such places as San Marino, Nepal, Andorra, Muscat, and Bhutan. Most of these nominal quotas will be largely unused, just as the quota for Great Britain is only one-third used, so that the total annual quotas of 154,657 greatly overstates the yearly emigration from these countries.

These new quotas provide some minor gestures toward racial tolerance. For example, the Asia-Pacific Triangle is given 100, the Pacific Islands 100, China 100, and India 100. Thus the Republic of India and the hilltop principality of San Marino are on an equal footing before the immigration laws.

A quota is determined yearly for each of the quota areas or countries, in most cases equal to one-sixth of 1 per cent of the population of the United States in 1920 having the same ethnic origin.



TABLE 16.5

## ANNUAL IMMIGRATION QUOTAS UNDER THE McCARRAN-WALTER ACT

Austria	1,405	Latvia	235
Belgium	1,297	Lithuania	384
China	100	Netherlands	3,136
Czechoslovakia	2,859	Norway	2,364
Denmark	1,175	Poland	6,488
Estonia	115	Portugal	438
Finland	566	Rumania	289
France	3,069	Spain	250
Germany, West	25,814	Sweden	3,295
Great Britain and Northern Ireland	65,361	Switzerland	1,698
Greece	308	Turkey	225
Hungary	865	South Africa	100
Ireland	17,756	U.S.S.R.	2,697
Italy	5,645	Pacific Islands	100
Japan	185	Yugoslavia	933

\* Excludes nominal quotas of 100 for minor countries, principalities, and territories.  
SOURCE: United States, Department of State, *Bulletin*.

Within each area quota three preferences are established. At least 50 per cent of each such quota is available to persons, with accompanying children and spouse, who are urgently needed in the United States by virtue of their education, experience, or ability, and who presumably will contribute to the national economy, culture, or welfare. Another 30 per cent of each quota is available to parents of citizens. The remaining 20 per cent of each quota is reserved for the spouses and children of aliens lawfully admitted for permanent residence. Any unused portions of these three preference categories are available to qualified quota immigrants except that 25 per cent of this balance shall be reserved for the brothers and sisters and sons and daughters of United States citizens.

The McCarran Act created a great deal of ill-feeling abroad and some concern at home. The enforcement of many of the provisions affecting foreign seamen while in United States ports was resented. It was pointed out that, in the case of countries having small quotas, relative to the need, it would be virtually impossible for anyone to enter the United States who was neither closely related to a citizen or resident nor an outstanding artist, scientist,

or professional man. In fact the Act effectively shut the door on thousands of persons displaced by the war and its subsequent territorial adjustments.

Hence, and partly to recover some goodwill lost abroad, the Refugee Relief Act was passed in 1953. It provided, prior to the end of 1956, for 205,000 special non quota visas for certain classes of immigrants and spouses and children under 21 accompanying them. The Act distinguishes between refugees, escapees, and expellees. The principal beneficiaries are German expellees and escapees (55,000 and 35,000 special visas respectively) now residing in the German Federal Republic, West Berlin, or Austria; refugees of Italian ethnic origin residing in Italy (45,000); refugees of Greek and Dutch ethnic origin residing in Greece and Holland respectively (15,000 each); and escapees resident within the European continental limits of NATO, Turkey, Sweden, and Iran, and not nationals of their area of residence (10,000). Extra visas are provided for persons of Italian, Greek, or Dutch ethnic origin, residing in Italy, Greece, or Holland respectively, and who qualify under one of the preferences stipulated in the Immigration and Nationality Act. The Refugee Relief Act exempted immigrants on special visas from normal fees. It further provided that a sum not exceeding \$5,000,000 should be made available for loans to special immigrants, with interest at 3 per cent, to help cover the cost of transportation to the United States.

In 1954 the Graham Amendment provided, in the case of Italy, Greece, and the Netherlands, that special visas available but not used by refugees should be made available for relatives having preferences under the law.

Also in 1954, to demonstrate that immigration policy is not outside special interest politics, Public Law 770 was enacted, permitting, for one year, the entry of 385 alien skilled sheepherders, without the assignment of a quota number, if the relevant quota were filled and if the sheepherder were coming to a permanent job.

Any assessment of United States immigration policies should note that the Refugee Relief Act, belatedly passed, permits the once-for-all issue of additional visas totaling a little over 200,000.

The annual quotas under the Immigration and Nationality Act total about 150,000. However the number issued is considerably less. For example, only about a third of the quota of 65,000 for Great Britain is used, and the French quota is not fully used. Various proposals to pool unused quotas each year, or to allow unused portions in one year to be credited to the next, have never been approved by Congress.

Including the net immigration of non quota nationals—about 50,000, and primarily from Canada—total net alien immigration into the United States is likely to be little more than 150,000 in most years. This is less than 1 per 1,000 of population and less than 1 per 25 births. In practice it is extremely difficult for most applicants, except native born Canadians and Britons, to enter the United States unless related to citizens. For many who do enter there is a wait of several years. And only a few hundred nonwhite immigrants can enter each year from outside the Americas. However, in 1957 the Administration again prepared a number of liberalizing amendments for Congress, including the regional pooling of unused quotas.

Today it can no longer be said that the United States is a land of hope and opportunity for the millions of Europeans who not so many decades ago would have been welcome. However the Congress, by keeping the door open for white people of special attainments, has by implication recognized the great contributions made to United States prosperity and security in the past by gifted immigrants. Considering, to take a single example, that without men like Einstein, Fermi, and Teller, American supremacy in the atomic arms race might never have been possible, it could surely do no less. Unfortunately consular officials cannot always predict, sometimes far into the future, which eager applicant may later contribute substantially to the welfare of the United States.

Nevertheless, apart from the issue of how much immigration to permit each year from quota countries, the present policy has two desirable features. Through the various preference schemes a real attempt is being made to (1) secure the largest possible number of immigrants having special attainments and (2) reduce as far as

possible the dismemberment of immigrant families. Whether the United States should really limit immigration to an annual rate of less than 1 per 1,000 of population, however, remains a matter of considerable debate.

### POPULATION PRESSURE AND OPTIMUM SIZE

There are a number of nations in the world today, such as Australia, Canada, and the United States, that enjoy a high standard of living, have a low ratio of population to resources, and exclude non-whites as immigrants. At the other extreme are a number of densely populated countries, such as India and Japan, inhabited by racially distinct people and where life for many is barely above the subsistence level. This division of the world is the cause of much resentment because, in the absence of immigration restrictions, it is commonly supposed that many million Japanese, Chinese, and Indians would move to the white man's lands of recent settlement. While there is little prospect of this happening in the predictable future, it is worth asking what the economic effects of such a massive migration might be and if it would reduce population pressures.

As for some facts, Table 16.6 indicates some contrasting population densities per square mile, populations in 1954, and approximate population increases in the last 50 years for several countries. Of course population density data have a limited meaning, as a disproportionate area of some countries may be economically useful. The table also gives birth, death, and infant mortality rates, the last two being reliable inverse indices of economic well-being.

Some of the numerical consequences of attempting to relieve population pressure through migration should first be pointed out. The population of the Dominion of India, for example, is increasing by about four million a year. It would take over 60 ocean liners such as the Queen Elizabeth, loaded to troopship standards, to move this number of people annually to the United States. At present rather more than a million people are annually transported across the North Atlantic—a very much shorter distance—by air

TABLE 16.6

POPULATION PRESSURE AND VITAL STATISTICS FOR SELECTED COUNTRIES, 1954

Country	Population (per Square Mile)	Estimated Popu- lation 1954 (millions)	Approximate Annual Increase in last 50 Years (in per cent)	Live Births (per 1,000 <sup>a</sup> )	Deaths (per 1,000 <sup>a</sup> )	Infant Deaths (per 1,000 Live Births)
Argentina	18	18.4	4.1	24.6	8.7	65.2
Australia	2.9	8.8	2.3	22.9	9.1	23.3
Canada	3.8	14.8	2.8	27.9	8.6	35.9
Union of S. Africa	27	13.2	2.5	25.7 <sup>b</sup>	8.9 <sup>b</sup>	34.1 <sup>b</sup>
United States of America	52	159.6	2.0	24.7	9.6	27.9
India	288	372	1.3	24.8	13.6	116.3
Indonesia	133	78.2	—	28.1	18.4	24 <sup>b</sup>
Egypt	57	21.9	2.1	44.7	19.3	128.6
Japan	600	86.7	—	21.5	8.9	49.4
Pakistan	206	75.8	—	—	—	—

<sup>a</sup> Excludes still births.<sup>b</sup> European population only.SOURCE: United Nations, *Statistical Year Book*.

and sea. It seems evident that the world's present fleet of passenger ships would be quite inadequate to transport the natural population increase of the more densely populated countries to the more sparsely settled ones.

Quite apart from whether such a migration is physically possible, it is questionable if this movement would do much to reduce population pressures in the densely populated countries. The spread of public health services is likely to lead to further reductions in the death rate in countries like India, Japan, and Egypt. The birth rate will continue high so long as child marriage continues and children in the rural regions are regarded as a sort of old-age insurance for the parents. Drastic changes in present attitudes to marriage, birth control, and filial responsibility will have to occur before large-scale emigration can be expected to do more than slow the impending population growth of these countries.

Nevertheless people have speculated on what might be the *eco-*

*nomie* effect if the United States were to accept several million immigrants a year. It seems safe to predict that hourly wage rates, weekly earnings, and the marginal productivity of labor would decline, perhaps markedly, in the port cities and their immediate hinterland. There would be some unemployment unless concerted action was taken to spread the immigrants throughout the inland cities and country towns. The owners of invested capital and land resources would probably experience an increase in real income. The greater availability of labor would cause some changes in the American way of living; the production of labor intensive goods would increase and personal services of all kinds would become cheaper. (Perhaps there would be 50¢ haircuts again.) These developments, quite apart from the social problems of assimilation, would provoke violent opposition from organized labor.

Accordingly some people have made an ingenious suggestion, namely, that newly-arrived immigrants should for some period of years receive lower wage rates than others, in recognition of their lowering of the marginal product of employed labor. Apart from some of the repugnant features and enforcement problems attaching to such a scheme, it should be realized that employers would then attempt, assuming the immigrants were not inferior workers, to hire them in preference to others. In organized trades this could probably be prevented by seniority provisions in the union contract. But in other occupations it might be necessary to limit the percentage of hires that could be new immigrants.

These rather fanciful ideas may perhaps be left in order to consider what may be a more real problem closer to home. Within the United States the rate of family formation is higher than it was 25 years ago, and full employment is raising the birth rate. Meanwhile medical science continues to lower death rates at all save the highest ages. This *natural* increase in the population of the United States—which excludes the effect of immigration—will result in a doubling of the population every 50 years if present trends continue. This would mean a population approaching 300 million by 2000 A.D. and exceeding one billion a century later. Under the circumstances it may not be out of place to con-

sider the sort of future population size that the people of the United States would wish for later generations.

The economist is likely to argue that, conceptually at least, the optimum population size is one that occasions the highest gross national product per capita. This will in the long run also result in the maximum value of consumption per head. It requires a labor force, which in turn depends on population size and social attitudes toward paid work, such that the marginal product and average product of labor are about the same. This will depend upon the aggregate ratio of labor to natural resources *and* to invested capital in the economy.

The extent to which natural resources can be increased without investment is severely limited. Hence one might expect that an increasing population would raise labor to land ratios in farming and so reduce labor's marginal product. However, over the recent past it seems that biological discoveries, new farm equipment, and special fertilizers and insecticides are not only postponing such a fall but are temporarily raising labor productivity in agriculture.

As regards the labor to capital ratio, in the United States this has been falling, because the net investment of the economy has been proceeding at a much more rapid rate than has the population. It is true that the population has been increasing, but today, whether working in an office, factory, farm, home, or one of the military services, each person is employed with far more labor saving and "output multiplying" equipment than even a decade ago. Also, more so than in agriculture, advances in the state of the arts are further increasing the productivity of labor in industry.

For these and other reasons there has been little if any concern in the United States over an excessive natural growth in population. Indeed, it is hopefully believed that new advances, such as atomic energy, will indefinitely postpone the day when population pressure will become a reality at home. However, while advances in the state of the arts may permit higher per capita output levels with a growing population over time, it may still be true that a smaller population would permit even higher per capita output and consumption.

The same point can be made regarding labor' to capital ratios. It is certainly true that output per man-hour of work has increased, partly because each worker tends to be employed with more capital to aid him. However, if the labor to capital ratio were still lower, as it might be with a smaller population, the marginal product of labor might be still higher.

In a way the problem can be turned around. Given a static economy with a constant population, labor force, natural resources, and state of arts, what is the aggregate value of the investment *stock* in the economy that will maximize output and consumption per worker? Theoretically, it is the stock of capital that renders its own marginal product zero. This is sometimes called the capital saturation point. It implies zero interest rates.

Interest rates are not zero in the United States, but does this mean that there is too little capital relative to labor? In a static economy it probably would. But the American economy is one of constant technical advance and capital innovation. These new forms of real investment have a high net rate of return. And such demands for loanable funds to make these new kinds of investments contribute to positive interest rates. This would probably be so even if the labor to capital ratio were considerably lower.

These theoretical considerations provide no definite answers to whether or not the United States is now approaching or has passed some sort of optimum population size. In a rapidly innovating economy loanable funds will earn interest, but this does not necessarily mean that the labor to capital ratio is too high. Still less does it necessarily mean that the population is too large: perhaps the solution is a larger annual net investment.

The best practical index of excessive population may be an increasing percentage of total employed labor devoted to providing the necessities of life. The recent history of the United States exhibits an opposite trend, with a decreasing proportion of the labor force engaged in agriculture. So far there seems no need for concern in the United States over population growth, whether caused by natural increase or immigration.



**PROBLEMS**

1. "United States immigration policy today is one of quality selection pure and simple, with preferences given to scientists and others likely to contribute to the national life." *Evaluate.*

2. "The immigrant who lives here and remits some of his earnings to his wife and family who are still abroad is subtracting from the real income of native born families here: he should bring them over here or go home." *Evaluate.*

3. "The economists' theorem that increasing labor to land ratios will reduce the so-called marginal productivity of labor has been disproved by the rising outputs per worker in agriculture during the last few decades." *Evaluate.*

4. "Theoretically each country has some population size, given the conditions of the times, that is economically the best." *Explain.*

5. "The United States has a greater choice of immigration policies than most people suppose." *Exemplify.*

# **PART V**

## **COMMERCIAL POLICY**



## CHAPTER 17

# United States Commercial Policy

We now turn to new terrain—the field of commercial policy. In the United States, commercial policy has traditionally been tariff policy, though the scope has lately been expanded to include quota policy and agricultural surplus disposal policy as well. Most other countries, on the other hand, rely relatively less than we do on tariffs. Though many of them have structurally simpler tariff systems than ours, they may be said to have more complex commercial policies. Thus, countries with tariffs and involved exchange control restrictions on imports, plus a variety of import quota arrangements, or discriminatory state trading systems necessarily pursue commercial policies that are more complicated—at least in a mechanical sense—than ours. An important point, in any case, is that commercial policy is not the same thing in each of the major trading nations.

### TO SEE OR NOT TO SEE IN PERSPECTIVE

We could proceed at once to the heart of United States commercial policy. If we did, however, we would run the danger of failing to see the forest while dutifully describing the various and sundry trees. It would be better to try to see the picture in perspective.

Fortunately, we are able to draw on the masterful commentary

which Professor Viner recently presented to a committee of Congress, a section of which is germane to the current discussion. Basing his observations partly on some 600 pages of expert testimony and drawing on his own unrivaled grasp of the subject matter, Viner has set forth the outstandingly distinctive characteristics of American foreign trade that all of us must bear in mind when thinking about our foreign economic policy.<sup>1</sup> In the first place, foreign trade is of relatively minor importance to the United States as compared with other countries. This may be shown statistically, for example, in the following table that reveals the ratio of exports to national product for a number of countries. Note that exports average only some 5 per cent of national product in the United States, but have a relative importance that is at least three times as great in other cases. What is the commonsense

TABLE 17.1

RATIO OF EXPORTS TO NATIONAL PRODUCT, SELECTED COUNTRIES, 1913-1952

	<i>United States</i>	<i>United Kingdom</i>	<i>Germany</i>	<i>France</i>	<i>Italy</i>	<i>Netherlands</i>	<i>Belgium</i>	<i>Sweden</i>	<i>Switzerland</i>
1913	6	22	20	20	13	50	55	24	46
1928	5	15	17	26	18	33	61	19	21
1938	4	8	8	10	14	26	37	15	14
1952	5	16	15	19	15	45	38	17	18

SOURCE: *Foreign Economic Policy*, Hearings before the subcommittee on Foreign Economic Policy of the Joint Committee on the Economic Report, Washington, D. C., 1955, p. 518.

meaning of such data? It is simply that the behavior of the economy isn't dominated by our foreign trade, as it is in many other countries.

Second, the United States operates under almost universal absolute advantages in production. That is, even most of the things we import can be produced here more efficiently—specifically, at lower real cost in terms of physical inputs—than in the countries

<sup>1</sup> *Foreign Economic Policy*, Hearings before the Subcommittee on Foreign Economic Policy of the Joint Committee on the Economic Report, Washington, D. C., 1955, pp. 595-597.

that sell the items to us. Exceptions are tropical foods and forest products and some minerals. Thus, the United States finds itself in an especially favorable situation—a situation that cannot be true of more than one country in the world.

Third, the United States is also in the unique position of having no balance of payments worries. In other words, our country does not have to concern itself with the effects of its domestic policies, or its commercial policy, on the level of imports in relation to exports or on our gold reserves. We may leave such effects out of account. We may do so because of the pace of technical progress in the United States, the slower rate of inflation here as compared with other countries, and our gold hoard at Fort Knox.

Fourth, another distinctive characteristic of our foreign trade is that it has played a stabilizing role for us. Concretely, purchases of our exports by others have been relatively stable, with the result that our shipments overseas have tended to dampen the United States business cycle.

Finally, our foreign economic policy is a vital part of our overall foreign policy because of our political leadership and economic predominance in the free world. The real meaning of this is that it is absolutely necessary, before committing ourselves in legislation, that we take carefully into account the outside impact of our major commercial policy decisions. In short, we have grave responsibilities to bear in mind when shaping our commercial policy; though we may have been able once upon a time to give in to domestic protectionist pressures when legislating on tariff matters, similar behavior today could be very damaging to the true national interest.

### HISTORICAL SKETCH OF THE AMERICAN TARIFF

From the beginning, our commercial policy has been predominantly tariff policy. We have been tariff-conscious since the birth of the nation. Thus Secretary of the Treasury Alexander Hamilton was directed in 1790 to outline a program for the encouragement and protection of domestic manufacturing. His famous *Report on*

*Manufactures*, which presented the theoretical basis for protection, stressed such views as military self-sufficiency, protection of the home market, and the infant-industry argument. Hamilton's report was a powerful plea for protection, yet it evoked comparatively little popular support at the time. The American economy was still predominantly agricultural, so that most individuals were much more interested in importing manufactures cheaply than in building up domestic industry.

Manufacturing in the United States was not greatly stimulated until the time of the European wars following the French Revolution. It is well known that during most major wars, young countries dependent upon imports find their domestic industry greatly encouraged by interruptions in the flow of trade. Napoleon's attempt to exclude British trade from the Continent, and the retaliatory British blockade of the European mainland, led in time to the American trade embargo. For some years, therefore, nascent domestic industry enjoyed the most extreme form of protection—cessation of imports. American prices skyrocketed, and numerous high-cost industries mushroomed. Both agriculture and industry were adversely affected, however, by the termination of the wars. Relief was sought in the form of tariff protection, the Tariff Act of 1816 being the result. By later standards, however, the tariff rates under this Act were low. Additional increases in rates were effected in 1824 despite opposition from interests in the South and the commercial classes of New England, and it was not until 1828 that high rates of duty were imposed.

The Tariff Act of 1828, however, was poorly considered and became the target of vehement criticism from the opposition, particularly in the South. (The Cotton South, which sold its goods mainly in free world markets, was consistently opposed to greater domestic protection because increased protection was identified with higher prices for manufactures.) Calhoun, the vigorous exponent of the position of the South, led a successful revolt against the law, and in 1832 lower rates of duty prevailed once more. But some opponents of protection were still unsatisfied, especially as regards the constitutionality of tariff-making by Congress. South Carolina,

for example, went so far as to pass a law in 1832 nullifying the national Tariff Act of 1832 as it applied to that State. The contention was that Congress had exceeded its rights under the Constitution. But by this time too many interests were dependent upon protection, and in any case, one's views of the matter depended on how one interpreted the Constitution. The issue was temporarily settled in the Compromise Tariff of 1833, which removed some duties and called for a reduction of all of the remainder to a maximum of 20 per cent during the next ten years.

This ambitious program had hardly begun, however, when there occurred a general decline in business as a result of the currency and banking difficulties of 1837. Since customs duties constituted the government's principal source of revenue, the protectionists seized upon the situation in 1841 to enact higher duties for revenue purposes. Duties averaging 30 per cent, and frankly protective in purpose, were embodied in the Tariff Act of 1842. During the next few years, however, the improvement in general business carried with it a desire for reduced duties. The result was a general lowering of tariff rates in the Tariff Act of 1846. Another cut in duties occurred with the passage of the Tariff Act of 1857, when the average rate fell to the lowest level since 1816.

The Civil War period was most propitious for increasing protection to industry. The tariff-minded Republicans now were virtually without opposition owing to the secession of the South. War expenditure necessitated greater revenues, so that internal taxes had to be increased. And higher tariff rates were deemed necessary both to offset the increased taxes on domestic manufactures and to obtain greater revenues. These circumstances were clearly reflected in the high-duty Tariff Acts of 1862 and 1864. Moreover, the weakened postwar position of the South was a prime factor in delaying the reduction of protection for many years to come. During the remainder of the century, fluctuations in the level of duty rates varied approximately inversely with the level of business activity—rates would go up in depressions and fall in better times. This period also saw (1) an increasing application of protection to agriculture, especially wool; and (2) a provision in



the Tariff Act of 1897 (Dingley Tariff) for reciprocity arrangements with foreign countries.

During the first three decades of this century, Congress passed three major tariff acts. The first, that of 1913 (Underwood Tariff), following victory of the Democratic party at the polls, resulted in the largest reductions in rates in 50 years. The second was the Tariff Act of 1922, which restored high protective rates, especially on agricultural products. This shift to increasing protection for agriculture obviously reflected the growing belief in the maturity of American industry and the correlative decline in the comparative efficiency of our agriculture considered as a whole. Despite the Tariff Act of 1922, our agriculture remained depressed during the generally prosperous 1920's, mainly because of the dislocation of agriculture following World War I. This situation set the stage for the third major tariff act, the Tariff Act of 1930 (Smoot-Hawley Tariff), originally designed mainly to aid American agriculture. Contrary to the original intention of Congress, the legislation actually achieved the highest general tariff on record. This tariff was not received favorably at home or abroad, and with the onset of the great depression, the stage was set for an attempt at thorough tariff reform—the American trade agreements program. Before we deal with this program, however, we shall discuss two things in detail: first, the nation's stand against trade discrimination; and second, the importance of imports.

### TRADE DISCRIMINATION

The United States was relatively unconcerned with discrimination in international trade before 1922. A brief reference to some early trade history as well as to some American economic history will clarify this statement

#### A BRIEF HISTORY OF THE MOST-FAVORED-NATION CLAUSE

In the pre-Christian era and up to modern times, problems in the field of commerce related, in the main, not to the rules by which international trading took place but to the right to trade

at all. During this early period, trading was regarded as the activity of adventurers. Everywhere, European traders were looked upon with suspicion, so that they generally had to work in an essentially hostile environment. Yet, so lucrative was this type of enterprise that the ability to carry on trade was regarded as a high privilege, and all manner of devices were employed by citizens of trading states to obtain such privilege. Thus, nation-states and trading municipalities sometimes waged war to obtain various gains. One such gain consisted of the right of their citizens to trade in the defeated country. The conditions of trading improved with the passage of time, and, during the Middle Ages, permission to trade increasingly took the form of well-defined personal grants. Numerous and varied personal privileges and rights were bestowed upon traders of different lands. The varied character of these rights emphasized the need for equal treatment. Finally, during the late Middle Ages, the problems of trading with the Middle East led to the development of the idea that commercial treaties should contain a pledge to the effect that the Western state or municipality would receive as favorable a treatment as that accorded to neighboring states of the Middle East. This idea was the origin of the well known most-favored-nation (MFN) clause so often found in commercial treaties.

During modern times, two distinct types of MFN treatment have developed. The first is known as the *conditional* form, or *commercial reciprocity*. Since this is the type of MFN treatment to which the United States was wedded from its founding until shortly after World War I, we may discuss the conditional form in terms of American history.

At the time of the founding of our nation, the world was in the last phase of the era of mercantilism. Our founding fathers were therefore very conscious of the harsh discriminatory policies of European states. Because of the European policies that existed at the end of the eighteenth century, the American government was more interested in obtaining rights to engage in commerce and navigation than in lower tariff duties abroad, which in any case were low and of minor importance. The exclusion of our

commerce and shipping, or the discriminatory treatment thereof, was combated by making the granting of improved treatment in the United States conditional upon the other country's elimination of practices inimical to our trade. The conditional MFN treatment thus consisted of the swapping of trade or tariff favors between two countries, with such favors or concessions being extended to third countries only for an *equivalent* concession. (It is misleading to use the term *concession* with respect to such action because the concession makes it easier for us to buy goods which we can produce only at a comparative disadvantage. But the terminology is well established, especially in the United States.) The basic shortcoming of the conditional MFN principle was the great difficulty involved in extending tariff concessions to third countries, because it was almost impossible to determine just what an equivalent concession was. In any case, third countries did not receive like concessions automatically, but had to bargain for them in each instance. In some reciprocity treaties, the United States even took the extreme position that third countries, desiring to obtain the same treatment accorded to the country with which the United States had just signed a treaty, could not offer an equivalent concession because the value to the United States of the original concession consisted in the concession's exclusiveness.

The second distinct type of MFN treatment contrasts sharply with the conditional form. Under the latter form, a concession granted to a particular (favored) country for a compensation does not entitle another (third) country with which a conditional MFN treaty exists to claim the advantages of the concession unless it offers in turn an equivalent concession. Suppose the United States and France are parties to a conditional MFN treaty, and that the United States by bilateral agreement grants a special tariff favor to Cuba. France is not automatically entitled to the same tariff rate as Cuba, but has to offer the United States an *equivalent* concession in order to be placed on a par with Cuba. In other words, the country with which there is a conditional MFN treaty has only qualified protection against an act making one country a favored country. Unless the treaty country is able to meet the

concession with one of its own (that is accepted as equivalent, it is in effect being subjected to discrimination. *Unconditional* MFN treatment, on the other hand, is designed to avoid the establishment of a most-favored nation (one favored more than others). The unconditional form of MFN, which had been adopted by most nations prior to 1914, is designed to maintain equality of treatment by assuring all states not discriminating against the commerce of the country in question that they will at all times be treated as favorably as the nation that is *most favored*. Under the unconditional form of the MFN clause, therefore, a concession to a third nation makes it favored only momentarily. In other words, it is really not favored in any effective sense, and the clause could more accurately be called the *equal treatment clause*. In the United States the unconditional form of the MFN clause has been adhered to since 1922. This clause in commercial treaties and agreements constitutes the pillar of protection against the discriminatory treatment of our trade.

The basic reason for our adoption of the unconditional form of MFN was that we faced a situation in which foreigners discriminated against our trade. We no longer exported just a few staple raw materials essential to foreign industry. Rather, we too began to export a wide range of manufactured goods. In consequence, foreigners would frequently treat our manufactured goods unfairly, though they were anxious to get raw materials and so did not discriminate against imports of such products. We now became sensitive to trade discrimination, and the shift in 1922 from the conditional to the unconditional form of MFN was our reaction to the new turn of events.

The unconditional MFN clause has worked only moderately well. All too often, nations would adhere more to the letter than to the spirit of the clause. For example, a country would sometimes make skillful use of what is called tariff reclassification. If a duty of 40 per cent applied to a tariff classification labeled "leather shoes for men," this country could favor, say, Country A, the only important world producer of leather shoes with crepe rubber soles. It would do so by setting up a new tariff classification labeled "crepe-

rubber-soled leather shoes for men." This new classification would then be dutiable at, say, half the rate applicable to ordinary leather shoes, or at 20 per cent. In a nominal sense, third countries producing shoes with crepe rubber soles qualified for the duty rate of 20 per cent, because they were parties to trade treaties or agreements containing the unconditional MFN clause. Actually, however, the new tariff classification was set up to favor one country's trade while still permitting the discriminating nation to adhere to the letter of the unconditional MFN clause. The classic example of tariff reclassification is found in a German-Swiss treaty: "Large dappled mountain cattle, or brown cattle, reared at a spot at least 300 meters above sea level, and which have at least one month's grazing each year at a spot at least 800 meters above sea level." By means of this language, the duty reduction was made to apply only to the product of a restricted area of a single country.

Unconditional MFN terms have also failed to prevent discriminatory treatment of American exports because the world has adopted all manner of non-tariff import restrictions. Many of these operate indirectly through elaborate administrative measures that seemingly do not lend themselves to effective treatment by means of clauses in treaties and trade agreements.

The MFN clause is not without significance, however. It is still our main protection against the more direct forms of trade discrimination; and when we have tangible evidence of administrative discrimination, say in connection with import licensing schemes, our government, by invoking the MFN clause, can sometimes induce countries to correct the situation.

#### **EXCEPTIONS TO AMERICAN ANTI-DISCRIMINATION POLICY**

In recent years, because of the extraordinary difficulties that other countries have faced, our government has seen fit to modify the American policy of unequivocal opposition to trade discrimination. We have done two things. First, we have winked at various forms of discrimination, for instance, those stemming from some exchange-control systems. Second, we have signed formal agree-

ments that authorize trade discrimination against us under specified circumstances.

The Anglo-American loan agreement, approved by Congress in 1946, illustrates the second case. Britain was hard hit financially by the war. She was unable to pay for all the imports that her people seemed to need. In particular, she found herself with ample soft (inconvertible) currencies but short of hard currencies such as the dollar. As a result, she favored imports from sources accepting payment in soft currencies. In order to reduce this growth of trade discrimination, and for other reasons, we granted the British a 50-year, low-interest-rate loan of \$3.75 billion. (This was to enable Britain to tide herself over balance of payments deficits for five years, but the loan was exhausted in two years owing to unforeseen difficulties.) The loan, by augmenting the dollars currently earned by Britons from export sales, was supposed to enable Britain to meet all her requirements payable in dollars.

Several provisions of the loan agreement are designed to prohibit the use by either party of discriminatory import quotas. Article 9 of that agreement provided some exceptions to the general rule. In effect, Britain was permitted to invoke discrimination against United States trade (1) when a non-discriminatory policy would have prevented Britain from using inconvertible (soft) currencies (for example, French francs, owned by British residents, that the French exchange-control authorities would not allow to be converted into, say, dollars) to buy needed imports; (2) when Britain found it necessary to assist, "by measures not involving a substantial departure from the general rule of non-discrimination, a country whose economy had been disrupted by war," or (3) when Britain imposed import quotas "having equivalent effect to an exchange restriction" that is permitted by the International Monetary Fund.

#### **DISCRIMINATION TO PREVENT THE CONTRACTION OF TRADE?**

A distinguished Norwegian writer, Ragnar Frisch, has proposed an ingenious scheme to avert large mutual contraction of international trade. Frisch would permit discriminatory import re-

TABLE 17.2

<i>Exporting Country</i>	<i>Importing Country</i>			<i>Total Exports</i>	<i>Surplus</i>
	<i>A</i>	<i>B</i>	<i>C</i>		
<i>A</i>	0	12	120	132	12
<i>B</i>	0	0	120	120	0
<i>C</i>	120	120	0	240	0
Total Imports	120	132	240	492	
Deficit	0	12	0		12

strictions for this purpose.<sup>2</sup> For the sake of simplicity, let us consider only three countries, *A*, *B*, and *C*, each measuring its trade in a common value unit. Assume that *A* exports 12 units to *B* but that it does not import anything in return from *B*, and that *C* imports 120 units from and exports 120 units to both *A* and *B*. The details are shown in Table 17.2. The number 12 in this Table under column *B* means that *B* imports 12 units from exporting Country *A*; similarly, the number 120 under column *A* and to the right of exporting Country *C* means that *A* imports 120 units from *C*; and so on. Note that *A* has an export surplus of 12 and *B* a deficit of 12. Total trade amounts to 492 units.

Frisch proposes that the principle of trade discrimination be accepted whenever its application will reduce the contraction of trade that would occur under a policy of non-discrimination. In Table 17.3, for example, it is assumed that *B* must eliminate its deficit of 12 and that *B* and *C* cannot expand their exports. This table shows that international trade would contract least if *B* eliminated *all* imports from *A*. The total trade would contract to 480 units, or by 12 units as compared with the original situation. The contraction has been limited to 12 units because *B* has discriminated against *A*; that is, *B* has balanced its trade accounts by cutting out imports from *A* without reducing imports from *C*.

Under a policy of non-discrimination, however, *B* would have

<sup>2</sup> See his papers in the *American Economic Review*, Vol. XXXVII, No. 4, 1947, and the *Review of Economics and Statistics*, Vol. XXX, No. 4, 1948.

TABLE 17.3

<i>Exporting Country</i>	<i>Importing Country</i>			<i>Total Exports</i>	<i>Surplus</i>
	<i>A</i>	<i>B</i>	<i>C</i>		
<i>A</i>	0	0	120	120	0
<i>B</i>	0	0	120	120	0
<i>C</i>	120	120	0	240	0
Total Imports	120	120	240	480	
Deficit	0	0	0		0

to reduce imports of specified commodities from C whenever it reduces imports of the same commodities from A. The balancing of accounts under non-discrimination will eventually produce the situation shown in Table 17.4. Country B cuts imports from A by 2, and from C by 20, while C cuts imports from A and B by 10 units each. The total value of trade is now 450 units, or a reduction of 42 units as compared with the original situation instead of a reduction of 12, as under trade discrimination. The contraction of trade under non-discrimination is three and one-half times as large as the contraction that would occur under a policy of discrimination.

TABLE 17.4

<i>Exporting Country</i>	<i>Importing Country</i>			<i>Total Exports</i>	<i>Surplus</i>
	<i>A</i>	<i>B</i>	<i>C</i>		
<i>A</i>	0	10	110	120	0
<i>B</i>	0	0	110	110	0
<i>C</i>	120	100	0	220	0
Total Imports	120	110	220	450	
Deficit	0	0	0		0

The conclusions suggested by the tables seem to be that there is a case for trade discrimination; but the case is more apparent than real. First, no account has been taken of the possibility of *retaliatory* action by countries that are the target of discrimination. The retalia-



tion could be so severe, in fact, that over-all contraction of trade might well exceed the contraction that would occur under non-discrimination. Second, discrimination would lead to a smaller contraction of trade only if all countries cooperated in abiding by the the right formula of discrimination (which would always be changing, and would be quite complex mathematically when more than three countries were involved). All countries would have to adjust their imports and exports to the changing requirements of the formula—without delays and haggling. In fact, so great a degree of international cooperation would be required that it would be just as reasonable to suppose that the nations could agree to adopt policies to *expand* total trade in preference to the negative policy of achieving minimum contraction by means of a complex system of discrimination.

There is a third and more fundamental objection to the Frisch argument for discrimination. His advocacy of artificial mechanisms that violate the principle of comparative advantage in effect assumes that nations benefit by taking in each other's washing. His proposal does not call for working toward a redirection of production and trade; yet such action is necessary to correct the basic factors that are responsible for the disequilibrium. Frisch's solution removes price competition as a factor in the determination of the volume and direction of world trade, whereas what is needed is to preserve and strengthen the price system.

### THE IMPORTANCE OF IMPORTS

The importance of imports may be expressed by a simple formula describing a nation's living standard. The living standard is equal to domestic production plus imports minus exports.

For many years, our exports have exceeded our imports, often by a big margin. For example, exports were twice as large as imports for several years after World War II. In fact, from the beginning of the World War I to 1956, we have had a surplus of exports of about \$115 billion, three-fourths of which has been made possible by our loans and gifts. It is this surplus which is often mistakenly called a "favorable balance of trade." Is it a favorable thing,

however, to have to tax our people in order to make gifts? Yet we have done that on a large scale. We shall, in fact, get a *quid pro quo* only if we eventually have an import surplus that is greater than the historical export surplus. There are only two exceptions to this statement: our employment and economic activity have been partially maintained by the export surplus in time of depression, and we have benefited by receiving such imponderables as foreign good will.

The gain in terms of good will is obvious, but it is not obvious that we should have an export surplus in order to maintain employment and economic activity during depression. An export surplus to fight depression is a beggar-thy-neighbor procedure: we inject new net purchasing power into our own economy, but there is an equivalent deflationary effect in foreign countries where, as a rule, the opportunities for combating depression by means of domestic policies are relatively limited.

The popular faith in export surpluses apparently is so deeply rooted that they are thought to be needed even in time of prosperity. Foreigners have also employed this argument. The main idea is expressed in the bald statement that productivity in the United States is so tremendous that the goods produced cannot all be consumed here. Accordingly, it is argued, we shall continue to have to make gifts to foreigners, not to relieve shortages abroad, but to relieve surpluses in the United States. Without gift shipments, our goods will glut our market, drive down prices, and bring on lasting depression. Unemployment and idle factories will reduce our level of living more than continued gifts would.

This is sheer nonsense. Except for occasional downswings in business, we have been consuming all we produce for 180 years. Although we have had depressions, they are not to be explained in terms of the naive over-production theory. If we were not giving goods away, we would not be paying the taxes to finance the giving. We may produce more of particular goods than consumers are willing to buy at remunerative prices, but the remedy for this very common situation is to adjust and adapt production to changing consumer demands.

The plain fact is that our position of world leadership requires that we let other nations *earn* (1) their import requirements and (2) the funds with which to repay dollar loans. Other nations cannot understand why the most powerful nation in the world, with unrivaled per capita productivity and rich and diversified resources, should impose handicaps to imports. Except for the group that believes in the naive over-production theory of depressions, they cannot understand why we impose the handicaps and then make them gifts or prevent them from repaying loans in the only way that they can be repaid—by selling us enough of their goods and services. Most foreigners do not like the idea of receiving handouts and they do not like to suffer the stigma of default on loans.

Another plain fact is that our imports are small and can easily be expanded to the benefit of producers abroad and consumers at home. Our imports are relatively low—less than 5 per cent of our gross national production. In short, the ratio of imports to domestic production is uncommonly small in the United States.

As is well known, firms earning money or men holding particular jobs because of tariff protection generally protest whenever there is any mention of proposals to lower trade barriers. This is their way of letting us know that they do not wish to make adjustments in the broad national interest. However, we, as a nation, confer monetary benefits on them and we, as a nation, can take away such benefits. We can deprive them of such benefits whenever we agree that, by imperiling our position of world leadership through what is in effect a system of public handouts, they no longer deserve them. As we have already seen, the protest consists of statements to the effect that high-priced American labor can't compete with "pauper" labor abroad, and the like. If we can't compete, why is it that our export surplus is so persistent and so large? Incidentally, foreign producers frequently complain to their governments that they need protection against products from the United States because their labor's productivity is an even smaller fraction of United States productivity than their wage rates are of United States wage rates! Actually, it is cheaper for protected industry in the United States to clamor—to buy space in newspapers, to hire lawyers to

present their case in Washington, and to lobby before Congress—than to make necessary adjustments. But it is now national policy to use all of the resources at the government's disposal to prevent sizable business depressions. Hence, there is no longer any reason why, given the need for a sound national and international economy, vested interests in *particular* articles of production or jobs should take precedence over the broad national interest.

### THE TRADE AGREEMENTS PROGRAM

We began our policy of expanding imports and foreign trade generally with the adoption of the reciprocal trade agreements program in 1934. Our aim was to reverse the world trend toward the multiplication of restrictions on trade. After having employed the single-column, unilaterally imposed tariff-rate system almost without exception since the founding of the nation, the United States abandoned this system in the second year of the first administration of Franklin Roosevelt. In its stead there was adopted the system of tariff reciprocity incorporating unconditional MFN treatment as a basic element. Tariff reciprocity is in contrast with the system of tariff-making in which rates of duty are constructed and put into effect unilaterally.

#### MAIN FEATURES

In every respect other than the manner in which they are negotiated, however, the trade agreements constitute a type of multi-lateral trade policy. Bilateral or reciprocal agreements that are extensible without discrimination under the unconditional MFN clause, that are reached by the executive branch of the government under specific authority delegated by Congress, and that involve a double-column tariff, constitute the central elements of the United States trade agreements program. The statutory authority for the trade-agreements program is the Trade Agreements Act of 1934, as amended.

It has long been believed that Congressional tariff-making and the operations of minority interests or pressure groups have been

responsible for a persistent upward bias in tariff rates. A more objective approach to the problem of tariff adjustment based on national or general interests was sought. It was felt that qualified personnel in the executive branch of the government, acting in coordinated fashion on the basis of the most authoritative data and expert advice, would be able to offer a more rational attempt to expand American participation in international trade. The United States, through the trade agreements program, would aim to expand world trade by simultaneously expanding imports into the United States and exports to other countries. Trade agreements, incorporating the unconditional MFN clause, would be negotiated with individual countries to achieve this end.

There were five salient features of the Trade Agreements Act of 1934. First, the President was empowered to lower or increase the then-existing duties by 50 per cent. It will be recalled that the tariff rates at the time were the highest in our history. Second, the President was specifically forbidden to transfer dutiable commodities to the free list or *vice versa*. Third, unconditional MFN treatment was to be provided. Fourth, reciprocal agreements embodying changes in duties were to take effect upon proclamation by the President; ratification by the Senate was not necessary. Fifth, authority to enter into such executive agreements was granted for a period of three years, after which the President's authority would terminate unless a new law were passed renewing his powers.

The mechanics of implementing the trade agreements program are comparatively simple. When negotiations for a trade agreement with a particular country are about to be undertaken, public announcement is made of the fact. Interested traders and producers are then notified about the commodities on which the United States proposes to make duty reductions. Parties which feel that they will be injured are requested to appear at public hearings conducted by the Committee for Reciprocity Information at which meeting their views may be made known. Information gathered at these hearings is then presented for consideration by inter-departmental committees which have been studying all available data bearing on a possible agreement. These committees propose reductions

in duties to be requested of the foreign country with whom negotiations are under way, as well as duty reductions which the United States is prepared to grant. In order that a bargain may be struck, duty reductions are confined to commodities of which the other country is the major supplier. The result is an enumeration, commodity class by commodity class, of concessions to be sought and concessions which may be granted. When these reciprocal concessions are finally agreed upon by the relevant committees and the foreign government, a trade treaty is signed by the President, and new rates of duty go into effect.

All along the line, the particular interests of different groups of Americans are considered, with an eye to the broad national interests as well as to the temper of Congress. Representatives on the inter-departmental committees often transmit, indirectly and by subtle means, the wishes of particular lobbies. The Department of Agriculture frequently pleads the case of the farmer, the Tariff Commission occasionally takes the side of protected industry, and the Department of Commerce seeks to improve the position of American exporters. Now and then letters from belligerent senators or congressmen, or even from cabinet members, serve to influence decisions. By and large, however, the trade-agreements procedure represents a real improvement over the logrolling tactics of Congress in tariff matters.

Progress was achieved slowly but surely during the first decade of the trade agreements program. Agreements were signed with 28 countries; in these agreements we made two types of concessions to foreign countries. On the one hand, there was binding of existing duties or binding of commodities on the duty-free list (binding is an act which freezes a given type of tariff or quota treatment, and in the case of low tariffs, free-list, and relatively large import quotas, is thus regarded as a favorable act by the foreign country with which an agreement is being negotiated). On the other hand, and more important than bindings, there were reductions in our rates of duty. At the end of the first decade of the program, duties on nearly half of the goods subject to agreements had been cut to the full 50 per cent permitted under the law. The average *ad*

*valorem* equivalent of rates assessed against dutiable imports in 1934 was about 50 per cent; by 1944 the average had been reduced to 37 per cent. Despite the tariff cuts, the average *ad valorem* equivalent of duties was still a good deal above the 1914-1920 level of 27 per cent.

(It is necessary to enter a word of caution as regards the interpretation of statistics concerning the average *ad valorem* equivalent of rates on dutiable imports. Specifically, it is not always correct to interpret a reduction in the average *ad valorem* equivalent of duties as meaning that a tariff is becoming less restrictive of imports. Statistical measures of the degree of restrictiveness of a tariff are misleading because the proportion of dutiable imports to total imports is reduced step by step with the restriction of imports. As tariff rates become more restrictive, therefore, there results a lowering rather than an increase in the average *ad valorem* equivalent. This is most clearly seen if rates are raised to such levels as to prohibit the entry of all dutiable imports, because in such a case the average *ad valorem* equivalent would be zero. When, however, specific rates are being reduced while others remain unchanged, it is helpful, though not strictly accurate, to compare tariff levels in terms of average *ad valorem* equivalents.)

#### EARLY POSTWAR LEGISLATION

By about the end of the war nearly half of the duty reductions that had been effected during the first decade of the trade agreements program had been for the full 50 per cent allowed under the law. Because of this, the President in 1945 requested and received Congress' permission to cut duties up to 50 per cent of the level in effect in 1945. This marks the second tariff-reducing authority that has been authorized by Congress under the program. (A third was authorized just a decade later, and is explained below.) The new 1945 authority meant that goods the duties on which had already been cut to the limit could now be reduced to 25 per cent of the 1934 level. Congress was convinced that it was necessary to enlarge the tariff-reducing powers of the President if the trade agreements

program was to continue to make a much-needed contribution to the lowering of trade barriers. The national mood of the time was one of international cooperation "to win the peace."

Did the power to reduce duties to 25 per cent of the 1934 level mean that the President was authorized to wipe out most of the tariff? Not at all. First, it must be borne in mind that the rates prevailing in 1934 were mostly at historic peaks and that many of the duties involved excessive and unnecessary protection—tariff relief over and above the minimum necessary to shelter inefficient American industry and agriculture. Second, most competing producers abroad were in no shape to act as strong rivals to us at this time, in view of the very extensive war damage to plant and equipment and the extraordinary demands on resources in the devastated countries. Third, the United States was now turning or preparing to turn increasingly to measures of a kind that assured producers that tariff-reduction would not cut too deep.

Thus, during the period in which the 1945 extension of the trade agreements act was in effect, the President issued an executive order (9832 of February 25, 1947) that established a procedure by which American industry would have some or all of its tariff protection restored if imports produced or threatened injury. This is the now-famous "escape clause," of the kind first used in the 1943 trade agreement with Mexico. (We return to this in a moment.)

The mood of Congress began to change as soon as foreign producers had begun to regain their production feet. Nothing showed the new mood more clearly than the 1948 extension of the Trade Agreements Act. First, Congress renewed the law for just a single year (previous renewals were for either three or two years). Second, an escape clause was written into the law itself. Third, Congress converted the Tariff Commission—heretofore a fact-finding body—into a policy-making organization. The Commission, not functioning as a part of the inter-departmental machinery as before but entirely on its own, was to decide the "peril points" of United States tariff concessions. These were the minimum tariff levels necessary to avoid the threat of serious injury to domestic industry producing an article under consideration for trade agreement conces-



sions by the United States. In making "peril point" determinations, the Commission was to consider only protection and to base its decisions exclusively upon the estimated needs of particular industries for protection.

But Congress changed its mind in 1949, when it extended the trade agreements act for two years. This time it deleted the provision conferring special powers of "peril point" determination on the Tariff Commission. The escape clause, however, still applied under the provisions of the executive order of 1947.

We could count on the protectionists keeping the kettle of discussion boiling pretty vigorously. Congress again renewed the Act for two years in 1951, but it restored the "peril point" provision substantially in the form in which it appeared in the 1948 law. If the President cut duties below such points, he had to state publicly why he did not carry out the Tariff Commission's recommendations. The next two extensions of the law were for just single years: Congress surely was not showing enthusiasm for the trade agreements program.

The extension act of 1951 is of particular interest because of the sharper definition of the escape clause. This Act provided that no trade-agreement concession

shall be permitted to continue in effect when the product on which the concession has been granted is, as a result, in whole or in part, of the duty or other customs treatment reflecting such concession, being imported into the United States in such increased quantities, either actual or relative, as to cause or threaten serious injury to the domestic industry producing like or directly competitive products.

Any escape-clause action taken by the President is to remain in effect, according to the law, only "for the time necessary to prevent or remedy" the injury.

In order to carry out this provision, namely, that relating to the duration of the escape clause, the President issued executive order 10401 of October 14, 1952. This established a formal procedure for review of escape-clause actions. Specifically, the Tariff Commis-

sion is to maintain continuous review of each case and to make periodic reports to the President. The first such report is to be made in each case within two years of the original escape action, and thereafter reports are to be made at intervals of one year as long as the trade agreement concession remains modified or withdrawn.

#### **THE HAT CASE**

We may review the highlights of a few cases under the escape clause. On the unanimous recommendation of the Tariff Commission, the President in 1950 suspended concessions on hats, imports of which had increased only \$1.5 million in 1949. Who were the producers in question? The answer is that they were not the hat industry, or the producers of women's hats, but "producers of women's fur felt hats valued at \$9 to \$24 per dozen."

The domestic producers were already suffering from a declining demand for women's fur felt hats when they were hit by increased imports. Firms with a large part of their business in women's hats were particularly affected. Moreover, the industry was relatively undynamic, showing a much less rapid increase in productivity than that which characterized the economy as a whole.

#### **SPRING CLOTHESPINS**

The duty on this article was reduced in two stages by 50 per cent, from a prohibitive level that prevailed before the last war. Imports rose markedly just after the war, owing to the backlog of demand, and then settled down at about a third of domestic output. Domestic production, in fact, increased while imports fell off in absolute terms. On the basis of these facts, the Commission rejected the complaint of the industry and ruled that the level of imports did not involve injury to home industry. Incidentally, the increase in imports represented a larger percentage of consumption than was true in the case of hats. This indicates that the "conditions" in which imports take place is important.

**HATTERS' FUR**

This case is similar to that of women's fur felt hats. Imports, amounting to only 5-6 per cent of home consumption, were hitting an industry that was on the decline. As a result, trade agreement concessions on hatters' fur were suspended in 1952.

**GARLIC**

A handful of producers in California, who could have avoided injury by substituting one crop for another, appealed for aid. By a four-to-two decision, the Commission ruled that the domestic industry had been injured. The President, however, sided with the minority on the Commission and refused to modify the trade agreement concession on garlic. He emphasized that the resources used in garlic production could readily be shifted to the production of other profitable crops.

Escape-clause decisions by the Tariff Commission have also been handed down in a number of other cases, a minority of which have been favorable to the industries that have sought increased protection. Only a minority of the Commission's rulings favorable to home industry has been approved by the President, as is indicated in a later chapter where we deal with the reactionary dangers in our commercial policy.

An idea of the kinds of industries, in addition to the above, which seek escape-clause actions is indicated by the following list: motorcycles, blue-mold cheese, groundfish fillets, silk scarves, linen towels, dried figs, candied cherries, briar pipes, wood screws, chalk, canned bonita and tuna fish, household china, lead and zinc, woolen gloves, and watches. Sometimes unusual products come before the Commission, a case in point being pregnant mares' urine.

**THE GATT**

Our discussion of the trade agreements program during the early postwar period would be incomplete without some reference

to the General Agreement on Tariffs and Trade (GATT), jointly sponsored by the United States and a number of other countries, which dates from 1947. Tariff and trade barrier reduction generally are effected under the GATT on a multi-national basis from time to time, within the authority which the President possesses under the Trade Agreements Act. We discuss the details in the next chapter.

#### **THE TRADE AGREEMENTS EXTENSION ACT OF 1955**

This Act, which extended the President's authority to enter into trade agreements for a three-year period, is noted for several features. First, it represents the third time that Congress has authorized duty reductions since the advent of the trade agreements program. Second, it simultaneously gave a new protectionist twist to the escape clause. That is, the law moved us one step forward on the duty-reduction front but a half step (or more) backward as far as the escape clause was concerned. Finally, it authorized the President to impose import quotas whenever he felt that imports of products essential to defense were entering in such volume as to endanger industries deemed to be necessary on national security grounds. These and other features of the Act are indicated in the following list of its main provisions.

1. Congress, in passing the Act, reiterated its position that the law "shall not be construed to determine or indicate the approval or disapproval . . . of the executive agreement known as the General Agreement on Tariffs and Trade."

2. The law spelled out the extent to which duties may be reduced as compared with rates in effect on January 1, 1955. Specifically, the President is authorized to reduce duties by a maximum of 5 per cent of the rates existing on January 1, 1955, in each of three consecutive twelve-month periods, the first such period beginning on July 1, 1955. If duties on particular products are not reduced in any one such period, authority for the 5 per cent duty reduction permitted in such period automatically lapses. That is, the authority to make reductions in 5 per cent "units" is not cumulative from period to period.

3. The Act also permits the President to deal in a special way

with duties which were higher than 50 per cent by reducing them to a level of 50 per cent (*ad valorem* or its equivalent). In doing so, however, (1) not over one-third of the duty reduction may take place at any one time, and (2) no part of any further cut may become effective until the immediately previous part had been in effect for a year. For example, if an item carried an 80 per cent rate (or its equivalent) in 1955, the rate could be reduced by ten percentage points in each of three years, if necessary in years subsequent to 1958.

4. The new law also authorizes the President to exceed the duty-reduction limitations set forth above if he decides that such action will simplify computation of duties on the commodities involved. Only a relatively few items are expected to fall within the scope of this authority.

5. To facilitate the attainment of an agreement with Japan, the law also permits the President to reduce by 50 per cent any duty existing on January 1, 1945, with respect to goods in which Japan is a major supplier.

6. Another new provision requires the President to submit a report to Congress each year on the operation of the trade agreements program, including information on new negotiations, modifications in duties, reciprocal concessions obtained in trade agreements, and other modifications made in existing trade agreements. (This requirement is in addition to a similar requirement which calls for a factual report to Congress by the Tariff Commission with respect to the operation of the trade agreements program.)

7. Before the 1955 Act the Tariff Commission did not make public its findings in escape-clause actions until 60 days after it had made its report to the President. The Commission is required under the 1955 law to make public such findings simultaneously with their submission to the President.

8. An important provision of the Act defines a "domestic industry" for escape-clause purposes. Thus, a "domestic industry producing like or directly competitive products" is defined in the law to mean that *portion* or *subdivision* of the producing organizations that turn out such products. That is, a multiproduct industry's output may be separated for escape-clause purposes so that any one

segment of the output may be treated as an "industry." This is bound to increase the protectionist effect of the escape clause, as we explain fully in Chapter 19.

9. Finally, the law contains provisions aimed principally at restricting oil imports on national defense grounds. Concretely, the Office of Defense Mobilization is required to advise the President whenever an article is being imported in such quantities as to threaten to impair the national security. An investigation is to follow. If necessary, the imports in question are to be "adjusted" (that is, quotas are to be imposed) to a level that will not threaten to impair the national security. Though parts of the domestic oil industry were the main forces backing "national security" legislation, it was not long before many other industries, having been unsuccessful in winning escape-clause relief, began to pressure ODM for relief on national security grounds.

During the first winter following the enactment of the law the ODM took action which clearly suggests the difficulties with this kind of legislation. It publicly threatened the oil importing firms with quotas if imports exceeded the previous year's ratio of imports to domestic production. Before the winter was over, however, domestic fuel supplies had become tight. So the ODM unembarrassed, reversed itself, again publicly. It now urged importers to do their utmost to help meet the unexpectedly high demand! Fortunately, the importing companies—who have excellent research and marketing staffs of their own and are probably much better informed than the bureaucrats in the ODM—had not taken the government's first warnings very literally. The lesson in this case is simple: an over-anxious and protectionist bureaucracy could have pressed for import restrictions contrary to the real public interest.

### PROBLEMS

1. "Expansion in trade is like introducing a new machine or a new technique." *Explain.*
2. "Now that the United States must play the role once played by Britain, the character of our commercial policy is of crucial importance to the problem of world order." *Evaluate.*

3. "The distinctive international economic characteristics of the United States economy makes the formulation of a liberal foreign economic policy comparatively easy." *Discuss.*

4. "The fact that our comparative disadvantage is increasingly concentrated in labor-intensive branches of agriculture and older nondurable goods industries means that it is necessary to discard the trade agreements program." *Evaluate.*

5. "Direct technological displacement has taken a heavy toll of American imports." *Explain.*

6. "Ever since the escape clause, the trade agreements program has been Janus-faced." *Explain.*

7. "The old cliché that free trade at home has made the American economy flexible and productive and that free foreign trade will make it that much more progressive and dynamic neglects the fact that foreign competition is highly concentrated in the competitive industries which already suffer from chronic excess capacity. It is thus imperative that the escape clause be used more liberally." *Evaluate.*

8. "The theorists overplay the argument for freer trade; we all know that import adjustment is marginal to internal growth." *Evaluate.*

9. "Since the great bulk of international trade is concentrated in a rather modest number of commodities, it doesn't matter whether United States commercial policy leans towards protectionism or freer trade." *Evaluate.*

10. "Reconciliation between financial policy and trade policy may have to be based on a choice between the second best of convertibility with systematic trade discrimination and the third best of nonconvertibility with a bogus multilateralism in trade." *Explain.*

11. "Because increased American efficiency develops unevenly in different lines, we would be deluding ourselves if we thought that an increase in American productive efficiency would put an end to foreign competition." *Explain.*

12. "Swiss watchmakers will tell you that the low trade-stimulating effectiveness of some American tariff rates that are low on paper reflects the feeling that although the rate may only be 20 per cent, any large increase in sales in the American market may result in a tariff of 40 per cent." *Explain.*

13. "Growing industries have no legitimate claim to protection in the form of the escape clause." *Evaluate.*

14. "The test of injury should be applied to an industry as a whole and not to a single product." *Explain.*

15. "The escape clause should be invoked liberally whenever an industry meets the test of defense essentiality." *Evaluate.*

16. "Despite over two decades of the trade agreements program, the fact remains that the American economy has displaced imports instead of imports displacing domestic production." *Explain.*



## CHAPTER 18

# The GATT

The history of international institutions shows that some were designed by their drafters as permanent only to have them stillborn or last a short while, whereas others were established as temporary or interim arrangements but actually turn out to be permanent. The General Agreement on Tariffs and Trade (GATT), of which the United States is a leading member, is an important illustration of the latter. It is to this institution that we now address ourselves.

### HISTORY OF THE GATT

After years of preparatory work and a big international conference at Havana a number of nations hammered out an elaborate blueprint for an all-embracing organization to deal with trade and related problems on a world-wide basis. We refer to the Havana Charter of an International Trade Organization (ITO), signed by delegates of 54 countries in 1948. Largely based on a United States draft, itself hedged about with compromises to satisfy the demands of this and that interest, the document finally had to run the gauntlet of "requirements" that were insisted upon by the other nations. An exceedingly complex document emerged, fraught with all manner of legalistic phrases, and covering everything from complex provisions to deal with the use of import quotas for balance-of-payments purposes to the nature of the guarantees that the underdeveloped countries should provide for investments from the advanced nations.

The Charter was to be the means of subjecting the trade of sovereign nations to an international code of conduct. It had a two-fold purpose. First, it set forth detailed rules of conduct with respect to nearly every aspect of government regulations involving international trade. Second, it sought to create a new international organization to interpret and enforce the rules.

What happened to the Charter, which was to have come into force when ratified by 20 signatory governments? The record shows that there was but a single ratification, and that conditional upon acceptance by one of the big powers. Why had the delegates at Havana risked all to put an unplayable ball in the world political court? The answer seems to be that the governments tried to reconcile too many divergent positions and hopes. The document was too complex; it tried to do too many things; and, especially, it was "wrapped up and swaddled in thick layers of exceptions and escape clauses." Such were the worms at the core of the Charter.

But some of the simpler parts of the document were salvaged. This was done ostensibly as an effort to put a few of the features of early drafts of the document to work in 1947 while the sponsoring governments hopefully awaited the elaboration and ratification of the Charter of the ITO. Specifically, a few of the leading governments making up the preparatory committee on the ITO document decided to push ahead with the establishment of machinery to do just one thing: to reduce trade barriers in a new way. This was not on a simple two-country basis, with only one pair of countries sitting around the table at any one time (as we had been doing in our trade agreements negotiations up to that year), but rather with many nations sitting around the bargaining table, each engaged simultaneously in a whole series of reciprocal trade agreements with a number of countries. The nations making up the preparatory committee decided to accelerate the reduction of trade barriers in the indicated manner by convening a trade-agreements conference in Geneva. To guide the negotiators, provide a set of rules that they could follow, and establish norms believed to be appropriate to multilateral trade agreements negotiations and the settlement of disputes, the sponsoring governments of the Geneva conference

made use of some of the simpler features of an earlier, and less complex, ITO draft charter. These rules and norms, which were intended as stop-gap arrangements, comprise the provisions of the General Agreement on Tariffs and Trade, which today constitute the framework of trade relations between 35 member countries doing some two-thirds of the world's trade. The United States is the biggest member of GATT, headquarters of which are in Geneva.

### STRUCTURE

Because of the circumstances under which the GATT was born, it has not been much of an institution in the organizational sense. In fact, it has only small quarters and a tiny staff. What the GATT amounts to is (1) a long schedule of trade agreement tariff concessions for each member or "contracting party," representing tariff rates which each country has agreed to extend to others; (2) a set of general provisions designed to protect the tariff concessions from nullification by other restrictive devices and to provide general rules for the conduct of international trade; and (3) a small informal organization that administers the Agreement among the "contracting parties." It is hoped that this small organization which is swamped with work will be succeeded by a larger—but not very big—and permanent agency to administer the GATT, to be known as the Organization for Trade Cooperation (OTC). At the time of writing, however, the OTC was still before Congress. Incidentally, United States membership in GATT is based on an executive agreement entered into by the President on the basis of authority under the Trade Agreements Act and his powers to conduct the foreign affairs of the United States. The President has not asked Congress to approve participation in the GATT, but he has asked the legislative branch for authorization to participate in the OTC. If the OTC is approved by Congress, the term "Organization" will replace the term "Contracting Parties" as that now appears in the GATT.

### THE ARTICLES OF THE GATT

We may proceed to outline the Articles of the General Agreement on Tariffs and Trade. Some of the original Articles, agreed to in 1947, were revised in 1954, and it is the latter that we shall discuss. At the time of writing all indications pointed to the early adoption of the revised Articles by the necessary two-thirds vote of the contracting parties. In the discussion which follows statements about relevant experience will be included in the case of as many Articles as possible, to point up the human interest aspects of a living document.

*Article I.* This is in the nature of a preamble. It sets forth the broad objectives of international trade which all countries share—raising living standards, high levels of employment, development of world resources, and expanding trade. The members agree to use the GATT above all to reduce trade barriers and to eliminate discrimination in international commerce.

*Article II.* This Article requires the contracting parties (1) to give each other unconditional MFN treatment, and (2) to avoid doing anything which will increase existing preferences in trade. The MFN clause, of course, has been a standard feature of American trade agreements. It is the no-increase-in-preferences clause that may need some elaboration. The United States, for example, grants lower tariffs or more favorable import quota treatment for historical reasons to Cuba and the Philippines; Britain does the same with respect to imports from some members of the Commonwealth; as does France in trade with her colonies. Article II does not require the elimination of such preferences. But it has sought to prohibit the establishment of new ones. That is, the general rule is that no new preferences, or increases in the level of existing ones, are to be allowed.

The no-new-preferences rule has met stiff opposition from some members, mainly Australia and Great Britain. As a result of this opposition, for example, Britain in 1953 succeeded in obtaining a

limited "waiver" of this Article. Under this dispensation Britain is able to grant wider margins of preference to colonial agricultural products that rely heavily on the British market, such as British Caribbean citrus fruit and tobacco. The waiver permits Britain to impose or increase duties on unbound items from foreign countries without imposing similar duties on duty-free goods from Commonwealth sources. This authority was subject to two conditions: (1) the waiver must not result in a "substantial diversion" of trade to Commonwealth countries, and (2) the waiver shall not apply to Commonwealth goods on which Britain has imposed duties since 1939. It is the job of the small administrative staff of the contracting parties to keep a watchful eye on the case and supply reports so that the annual conferences of the members may see to it that only those actions are taken that conform to the conditions of the waiver.

*Article III.* This Article makes the concessions arranged in GATT tariff negotiations an integral part of the Agreement. The Article also contains several provisions designed to prevent impairment of the value of the concessions. For example, it states that members may not alter methods of determining dutiable value if the effect of such alteration involves impairment of a concession.

*Article IV.* Provisions at this point are designed to prevent the nullification of concessions under the guise of internal taxes or domestic regulations of trade. Experience has shown that such measures have frequently been applied as disguised barriers to trade.

*Article V.* Most countries have regulations governing trade in transit through their territory. This Article seeks to ensure that no member of the GATT hinders or discriminates against another member's trade by way of transit regulations.

*Article VI.* This Article condemns dumping if it threatens or causes serious injury to existing industry in a member country. It also sets forth the manner in which a member may protect itself by using anti-dumping or countervailing duties under suitable safeguards.

*Article VII.* Valuation for customs purposes is covered in this

provision. Actual value is prescribed, and standards set forth for its determination.

*Article VIII.* The language of this Article establishes standards governing the use of customs fees and formalities so that these may not be used as disguised barriers against imports.

*Article IX.* Marks of origin are covered in this provision, to ensure that they are not used to restrict trade or operate in a discriminatory manner.

*Article X.* This Article requires members (1) to publish promptly all laws and regulations affecting international trade, and (2) to administer such laws in a uniform way.

*Article XI.* Articles IV through X are known as technical Articles. We return to those having greater substance, or that involve greater issues of policy. Article XI contains a general indictment of quantitative restrictions on trade—import prohibitions, quotas, and licensing systems—and calls for their elimination. But the general indictment is followed by some exceptions. Specifically, import quotas are permitted to be used to restrict imports that would undermine domestic price-support and production-control programs in agriculture (discussed in detail in the next chapter). The indicated restrictions on imports, however, may not be such as to reduce the ratio of total imports to domestic production below the ratio that might reasonably be expected to rule in the absence of import quotas. (Query: Would not any quota restrictions that were effective run afoul of this proviso?)

In this connection, it may be pointed out that United States quota restrictions on dairy and other farm products, imposed under Section 22 of the Agricultural Adjustment Act, have been strongly criticized by a number of member countries that depend heavily on exports of such products. We elaborate below.

*Article XII.* This constitutes a huge exception to the general rule against the use of quantitative restrictions (QRs). Concretely, members in "balance-of-payments difficulties" are authorized to use such restrictions in order to safeguard their monetary reserves. Annual consultations are required, in order that the restrictions may

be removed or modified as improvement occurs in the balance of payments. If modifications are not made when improvement has occurred in the balance of payments, other members will be advised that they are entitled to take appropriate reprisals. Incidentally, the United States stands to gain more than most countries from the elimination of the tangled web of balance of payments restrictions. The consultations under GATT's auspices may deal with "alternative corrective measures which may be available," as well as with "underlying causes of disequilibrium," but it is doubtful whether the GATT has authority to examine such basic domestic policies as those in the field of monetary and fiscal affairs. The United States, it may be added, has made frequent protestations under Article XII.

Some progress has been made in recent years in reducing the use of QRs for balance of payments purposes. But this progress has been achieved mainly by way of national reform in the national interest, and the use of regional arrangements typified by the EPU. Perhaps the future may see a relatively greater role played by international machinery such as the GATT.

*Article XIII.* The terms of this Article state that members imposing QRs under one of the exceptions must apply them in a non-discriminatory manner.

*Article XIV.* This again sets forth exceptions to a rule—that of nondiscrimination in the use of QRs. Concretely, the Article allows a member to apply QRs in a discriminatory way if the restricting member faces balance of payments difficulties and a major country, such as the United States, is depressed and thus behaving in such a way as to result in the reduction of international trade if the rule of nondiscrimination were to be applied. To illustrate: if France has only a limited amount of dollars but plenty of inconvertible currencies (which can be spent only in certain countries), France's inability to discriminate against the United States would mean that France's imports would be reduced. Article XIV thus does substantially what is permitted under EPU and the IMF, a practice to which the United States has given its reluctant approval. As in the case of Article XII, however, it is doubtful whether the GATT

legally could delve into some of France's basic economic policies, such as monetary and fiscal policies, to get at the root of her difficulties. GATT-permitted trade retaliation, or threats thereof, might be effective, however.

*Article XV.* This Article seeks to prevent members from circumventing GATT through the use of exchange control restrictions having equivalent trade-restricting effects as QRs. It calls for cooperation with the IMF; the aim is to assure that countries do not take actions in the foreign exchange field to frustrate the intent of the GATT nor by trade actions frustrate the intent of the Fund agreement. In short, the authors of the GATT recognize that exchange controls and import quotas are largely alternative methods of regulating international trade. But the so-called underdeveloped countries receive special treatment. They have balance of payments rules of their own, as will be shown when we discuss Article XVIII.

*Article XVI.* This deals with export subsidies. If a member offers such subsidies so as to seriously prejudice the position of other members, the former may be required to explain its stand and possibly to limit or eliminate the subsidization. A distinction is drawn between subsidies on manufactured goods and on "primary" products. Subsidies on the former are to be banned after 1957. But the provisions regarding subsidies on primary products are mild—for the reason that some of the big members, the United States perhaps more than any other country, actively subsidize exports of such goods. The result is that Article XVI gently states that there is to be no subsidy on a primary product that secures to the country "more than an equitable share of world export trade in that product." There is no definition of "equitable share."

The problem of export subsidies creates a lot of heat at international meetings. At a recent session of the International Cotton Advisory Committee, for example, the British led a long list of countries in using Article XVI to criticize the United States policy of subsidizing exports of cotton. The GATT "share doctrine" made little sense in this case, as others saw the matter, since high United States price-supports were (1) overstimulating domestic *and* foreign production and (2) favoring synthetic fibers over cotton, and thus



making the outside world progressively less dependent on American cotton. In fact, cotton experts at the time were agreed that in view of the declining "cotton deficit" outside the United States the United States could regain its earlier share of the world's cotton trade, for a period, only by an export subsidy policy that, by inducing a collapse of world prices, ran the risk of bankrupting friendly foreign producers of cotton.

*Article XVII.* State trading is covered by this Article, that is, foreign trade that is conducted not by private parties but by the government. The provisions state that such trade is to be nondiscriminatory and based on commercial considerations of price, quality, and marketability rather than on political factors.

*Article XVIII.* This much-discussed Article, dealing with government assistance to economic development, is a radical revision of the original version. This is because the countries covered are granted considerable leeway. Two forms of underdeveloped countries are recognized: (1) those in early stages of development, such as India in Asia and Haiti in Latin America, and (2) those that are well along in the process of development, such as Australia.

Countries in category (1) are given great latitude in regard to both tariffs and quotas in protecting industries which they feel are essential for economic development. They may negotiate with other GATT members for the modification or withdrawal of tariff concessions. If they are unsuccessful in such efforts, they may appeal to GATT for help. Also, when they use QRs for balance of payments purposes, their case will be reviewed by GATT only biennially instead of annually as in the case of other members. Finally, they may use QRs to protect a newly established industry, but must first consult GATT. On the other hand, countries in category (2) must first obtain GATT's permission before they may use QRs to protect a newly established industry. The liberality of these provisions reflects a hard reality: the underdeveloped countries are a majority of the sovereign states in the world. And they never tire of reminding some of the advanced countries, particularly the United States, of their own history of protectionism.

*Article XIX.* This Article is the "escape clause" in the Agree-

ment, and is similar to the escape clause in American trade agreements.

*Article XX.* General exceptions to the Agreement are set forth in this Article, which permits the adoption or enforcement of measures to protect public morals, human life, health, and so on, as well as measures deemed necessary to implement intergovernmental commodity agreements. (The latter are discussed in a subsequent chapter.)

*Article XXI.* Security provisions are covered in this Article. That is, it permits a member (1) to limit the furnishing of information against its security interests, and (2) to control traffic in fissionable materials and arms.

*Articles XXII and XXIII.* The former sets forth procedures of consultation under the General Agreement, while the latter deals with the methods by which members may complain about actions deemed to nullify or impair a benefit under the Agreement.

*Article XXIV.* The main feature of this Article relates to customs unions, that is, multi-country arrangements by which customs barriers are partly or wholly removed with respect to trade between the participating nations. In general, customs unions may be formed if the duties and other trade regulations that the union applies against non-members will not be higher, or more restrictive, than the average of those previously applied by the individual countries forming the customs union. In other words, members may form a customs union or unions if those that join reduce barriers to trade among themselves rather than absolutely increase barriers as between themselves and countries not forming a part of the union.

*Article XXV.* This Article outlines the nature of the new Organization for Trade Cooperation (OTC) which is intended to replace the existing small administrative set-up of the GATT. We discuss the matter below.

*Remaining Articles.* The remaining ten Articles are largely technical and of relatively small significance in the present discussion. For example, they cover questions about the entry into force and application of the General Agreement, rules governing the withholding or withdrawal of concessions, the modification of tariff

schedules, procedures to be followed in tariff negotiations, rules for the submission of amendments to the GATT, withdrawal of members from the General Agreement (which requires notice of six months), the definition of a contracting party, the requirement of a two-thirds vote for admitting new countries to membership in the GATT, and the nonapplicability of the General Agreement under some conditions as between a member and a country which has newly joined the GATT (the so-called "Japanese provision").

### THE ORGANIZATION FOR TRADE COOPERATION

The President has tried unsuccessfully to win approval of the OTC from two sessions of Congress. This is of some significance. How do we account for the outcome? We may first describe the proposed OTC and then attempt to answer the question.

The OTC is to be responsible for administering the General Agreement. It will consist of an Assembly, made up of all members, an Executive Committee comprising 17 members elected by the Assembly, and a Secretariat or professional staff under a Director-General. In short, the OTC is to be a permanent set-up that is intended to improve the efficiency of the apparatus for administering the GATT. It should be contrasted with the way in which the General Agreement is now administered, which is by the same cumbersome process by which the GATT was negotiated, namely, by all the countries getting together in annual conferences.

Some members of Congress, and their protectionist supporters, oppose the OTC for the same reasons that they oppose the GATT: they fear that approval of these institutions by Congress will allow control of United States trade policy to fall into the hands of foreign governments. They argue that American membership in GATT is based only on an executive agreement; that congressional approval of the "organizational clauses" of the GATT (that is, the OTC) would be a backhanded approval of GATT itself; and that GATT members are free to amend the General Agreement without consent of Congress.

It is true, of course, that the United States is a member of GATT on the strength of an executive agreement. It is also true that GATT members are free to amend the General Agreement under specified rules. But it is not true that Congress' approval of the OTC would automatically imply congressional approval of the GATT. First, Congress has specifically stated in extensions of the Trade Agreements Act that it neither approves nor disapproves of the GATT. Second, other countries have an important economic stake in trade agreements with the United States, just as the United States has in its trade agreements with them (we do about three-fourths of our total foreign trade with other GATT countries). Are the other countries going to try deliberately to force unacceptable provisions upon the United States, the world's largest trading nation and the country with a uniquely strong economy, and run the risk of jeopardizing their stake in the American market? Third, let us assume that other GATT members would be so foolish as to try to force an unacceptable GATT down our throats. Would we be defenseless in such an event? Not at all. We could pull out of the GATT. Or, what is the same thing, Congress could repeal the legislative basis of the President's authority, the Trade Agreements Act. We would then be the "free agent" to which the protectionists would have us aspire. Surely such senseless economic isolationism would hardly be in the national interest.

There is a further word that may be added. We refer to the mistaken notion that GATT is largely a mechanism by which the main trading nations get together to negotiate tariff reductions. The reduction of tariff barriers is indeed one of its major functions. But experience has shown that the General Agreement means a great deal more. The GATT is also a peace-maker among the trading countries of the free world. Some observers would even state that this is its biggest function. They have in mind GATT actions under its provisions for the avoidance of trade restrictions and discrimination and in the settlement of trade disputes.

One of the first such settlements is of interest, that involving a dispute between Australia and Chile. Australia had been subsidiz-

ing the manufacture and sale of an artificial nitrate. Chile felt that this was harming her exports to Australia and was negating a benefit which she was entitled to receive under the GATT, having previously negotiated a tariff concession on nitrate with Australia. The Australians heard the Chilean case in the GATT and decided to extend their subsidy to both the imported product and the domestic product.

Norway had been concerned for some 30 years over Germany's discrimination against Norwegian sardines, a principal export. The case was brought to the GATT. After carrying out discussions within the framework of the General Agreement, the parties reached a settlement that was satisfactory to Norway.

Moreover, there are many actual or prospective violations of GATT that never have come before the contracting parties. Many of these have been resolved simply by way of bilateral consultations based on the GATT's provisions.

### THE WAIVER ISSUE

The United States is a foremost backer of GATT and perhaps the world's loudest champion of lessening restrictions on trade. But we, as well as some other members of GATT, don't always practice what we preach. In fact, some of our own actions speak so loud that what we say cannot be heard. The special privileges which we have obtained in order to restrict agricultural imports despite the GATT are an outstanding example of such actions.

Section 22 of the Agricultural Adjustment Act occupies a central place in the present discussion. Briefly, our agricultural price-support programs result in domestic price levels that are above world price levels, so that the United States attracts imports from abroad. Section 22 authorizes the government to restrict imports which interfere or threaten to interfere with the operations of agricultural price support programs. Acting under this authority, the United States has imposed quotas that virtually exclude imports of a number of important farm products. This action, which is precisely what

Article XI of the General Agreement says a member may not do, is one reason why Congress has been lukewarm about GATT.

Despite objections from other members, the United States has refused to eliminate import quota restrictions under Section 22. Our government has found it necessary, therefore, to ask a waiver from other GATT signatories so as to allow us to continue our restrictive policy. Given the importance of the American market for imports in general, other members had no choice but to oppose the United States and risk the life of GATT or to grant a waiver. They reluctantly chose the latter, partly on the basis of a United States promise to effect a gradual reduction in restrictions on agricultural imports. But the others did not grant a waiver before putting up a serious diplomatic fight. No country was more profoundly disturbed than Canada. In fact, the Canadians did the extraordinary thing of sending three key cabinet officers on a one-day flying trip to Washington in an effort to impress the Administration with the damage being done to GATT (and to Canada) by American insistence on quota restrictions under Section 22. The Canadians (and other members of GATT) could not acquiesce in one-sided American protectionism. After all, the Canadian authorities for years have opposed a number of Canadian industries that have asked for protection by pointing out that their individual cases, however deserving, had to be overruled by the need to preserve the general structure of GATT. Thus, it was embarrassing for Canadian officials—as for those of other governments—to ask their people to accept strict obligations while waiving the application of those obligations to the United States.

The Canadians failed in an effort to get a better balance between "*quid*" and "*quo*." A crisis of GATT was finally weathered, but not in the spirit of the central features of American foreign economic policy. Clearly, the case shows the seriousness of the waiver issue and the need to win wider public understanding of the relation between domestic agricultural policy and our foreign economic policy. As previously suggested, some other countries must also re-examine their attitude toward GATT waivers.

### TREATMENT OF JAPAN

There is another aspect of GATT that deserves some attention. We refer to Article XXXV and its application to Japan, the strongest free-world state in the Far East, when that nation was admitted to membership almost a decade after the founding of GATT.

Article XXXV deals with the nonapplicability of the General Agreement as between a member and a country which has newly joined the General Agreement when one of the parties refuses to apply the GATT's provisions to the new member. That is, the Article permits old members to treat some new ones as "second-class" members. Concretely, about half of the old members decided that they would neither extend to nor receive from Japan full MFN treatment in their mutual trade. They did so because of their fear of competition from low-cost Japanese producers in some lines of production. Hence, they continue to maintain strict quota and other restrictions on imports from Japan.

Discrimination by some GATT signatories against Japan is not to continue indefinitely. Members that decided not to extend or receive MFN treatment also assured Japan that they would work for the full application of GATT provisions to that country. For its part, Japan's membership in the General Agreement means that her voice will be heard with added respect in the councils of GATT. Among other things, membership will facilitate the task of persuading Japan with respect to the responsibilities of appropriate international trade conduct, especially as regards the use of concealed export subsidies.

### POSTSCRIPT ON QRs

The theory of GATT, as has been indicated above in an indirect sort of way (because the discussion has been confined largely to summary statements of the Articles of the General Agreement), is that QRs are to be governed by rather strict rules as modified in identifiable situations by specified exceptions. What about experi-

ence to date? The record shows something rather different, especially in western Europe. Specifically, quantitative restrictions in practice are becoming subject to international negotiations within the GATT, just like tariffs. Instead of practice conforming to the GATT principle that members are not to receive any compensations for relaxing import quotas, we are witnessing interesting cases in which countries with comparatively low *ad valorem* tariffs are demanding and receiving compensation in various forms for the elimination or reduction of strictly protective import quotas. This is an interesting trend. It suggests that pressure for freer trade in the national self-interest of some trading nations may yet break the will of other states to persist in some of the worst forms of protectionism. The progressive nations have a powerful ally in sustained high-level economic activity, the condition in which continued improvement in economic well-being is seen to depend on various ways of increasing efficiency rather than on policies under which nations try to lift themselves by their own bootstraps.

### PROBLEMS

1. "There is some doubt as to the wisdom of the great emphasis the United States has placed on nondiscriminatory multilateral trade." *Evaluate.*

2. "We should reduce our emphasis on tariff reduction in our foreign economic policy inasmuch as our tariff cuts have played a less important role than foreign aid and high levels of domestic employment in enabling other countries to pursue more liberal trade policies." *Evaluate.*

3. "United States policy is wrong, since insistence on equal treatment of American exports has increased the balance of payments difficulties of other countries." *Evaluate.*

4. "Other countries' balance of payments difficulties are only a datum as far as their economic policies are concerned." *Evaluate.*

5. "The OTC represents only an attempt to sneak the nose of the ITO under the tent of American foreign economic policy." *Evaluate.*

6. "Most GATT members judge good behavior not in terms of maintaining the status quo of agricultural import quotas but of gradu-



ally reducing the restrictions on lines that were promised, albeit vaguely, by the United States when the waiver was granted." *Explain.*

7. "The waiver obtained by Britain in effect regards the British market as part of the domestic colonial market for the goods involved." *Explain.*

8. "The General Agreement's provisions give the underdeveloped countries *carte blanche* to do what they wish in infringing the basic GATT code." *Evaluate.*

9. "It would make nonsense of GATT if members obtained unrestricted use of, say, tariffs, quantitative controls, and export subsidies." *Explain.*

10. "GATT's no-new-preference clause is sure to usher in an era of free trade." *Evaluate.*

11. "The revised GATT has done little to tighten up the rules on the use of artificial restrictions by countries in balance of payments difficulties." *Explain.*

12. "Restrictions imposed for balance of payments reasons are now one of the main devices used to protect home industry and agriculture." *Explain.*

13. "Our agricultural protectionism increasingly puts the United States in the position in which our actions speak so loud that what we say about the liberalization of trade can't be heard." *Explain.*

14. "The GATT allows a customs union to be formed when its effect is trade-creating." *Explain.*

15. "The reluctance of Congress to extend the Trade Agreements Act for more than three years at a time except under progressively stricter limitations proves that the GATT is not a permanent part of our foreign trade policy." *Evaluate.*

16. "GATT's power of self-amendment without the consent of Congress means that a vital phase of United States foreign economic policy is under the domination of foreign countries." *Evaluate.*

17. "The formulation of GATT rules, coupled with elaborate provisions for exceptions to rules and exceptions to exceptions, produces a situation that is tantamount to trying to put one's trousers on two legs at a time." *Evaluate.*

18. "Without going into details of GATT mythology and verbiage, it can be said that for all practical purposes the effort to enforce the rule against QRs in the agricultural field has been abandoned." *Discuss.*



## Reactionary Dangers in Our Commercial Policy

Though our over-all commercial policy for over two decades has been veering toward freer trade, there are some significant features that run definitely counter to the trend. We refer particularly to agricultural protectionism and the subsidization of agricultural exports, more or less reactionary "escape clause" measures by which we rescind trade agreement concessions or threaten to do that, and "anti-dumping" devices that backhandedly increase barriers to American imports. It is to this trio of reactionary or potentially reactionary policies that we now turn.

### AGRICULTURAL POLITICS AND TRADE POLICY

Special assistance to agriculture, in the form of measures to improve the income position of farmers, has been an important part of American political life since at least the 1920's. Perhaps the main development in the years following World War I was the use of the concept of "fair exchange value" in several bills to assist agriculture. Farmers, in the view of Congress, were entitled to a market price that reflected "fair exchange value." But the bills to which we refer were vetoed by President Coolidge, and so it was not until 1933, in the Agricultural Adjustment Act of that year, that the legislative basis of modern agricultural policy finally took definite shape.

### PARITY

The 1933 law dropped "fair exchange value" and put the concept of "parity" in its place. Today, parity is a household word, even though its precise technical meaning is not widely known.

Parity is a price relationship. Originally, Congress defined it in terms of the prices that prevailed on the average in the period 1910-14. Specifically, parity was defined as the 1910-14 relationship between the prices farmers received for their output and the prices farmers paid for the things they bought. If a bushel of wheat was sold in the base period for \$1 and a pound of ingot steel for 2 cents, the "pairity" relationship would be one bushel of wheat is equal to 50 pounds of ingot steel. Wheat today would be below parity if it fetched less than 50 pounds of steel and above parity if a bushel exchanged for more than 50 pounds. Speaking generally, the purpose of farm legislation is to assist farmers in receiving prices that are a high percentage of parity. At first, it was felt that farmers should attain parity slowly and mainly by way of production adjustments. By 1939, however, Congress shifted to programs of "supporting" the prices of basic commodities, such as wheat. Support levels of about 90 per cent of parity have prevailed for most of the period since then.

### PRICE SUPPORTS AND SURPLUSES

The mechanics of support are essentially simple. Farmers have the choice of selling their output in the market at prevailing market prices or of turning their product over to the Commodity Credit Corporation as collateral for a non-recourse loan at, say, 90 per cent of parity. In the latter case the farmer receives cash equal to 90 per cent of the support price times the quantity turned over to the CCC. If he does not repay his loan, the CCC would be without recourse to him; in that case the CCC would simply take legal possession of the collateral. (Clearly, the farmer would repay and repossess his product if the market price moved above the support level.)

Agricultural price supports have priced farm commodities above the market in most years since World War II. The effect of such price-fixing has been the same as all government operations of that type—much more is produced than consumers wish to consume at the fixed prices. Mountains of surpluses accumulate in government warehouses. Billions of dollars are tied up in the surpluses; moreover, at the time of writing it was costing a million dollars a day just to store the goods.

Three points deserve emphasis. First, high price supports overstimulate production. Second, to avoid huge surpluses in successive crop seasons, it becomes necessary for the government to impose acreage (production) and/or marketing controls. But, third, acreage controls don't limit output sufficiently as long as there is an attractive price incentive to use intensive methods of production on the restricted acres. The upshot, therefore, is that while farmers are indeed assisted they are not helped in such a way as to provide a permanent solution to the "farm problem," nor has the system of help served to mark progress toward the goal of removing the need for assistance to American agriculture.

#### INTERNATIONAL ASPECTS—INTRODUCTION

What has all this to do with the subject of *international* economics? Rather a good deal, as we shall see. First, it would be foolish to promise higher-than-world prices to farmers and then let imports enter freely so as to frustrate efforts to raise domestic farm prices or to keep them high. Hence, domestic price-fixing usually requires the imposition of restrictions on imports of commodities covered by price supports. Indeed, most of the import quotas that exist in the United States apply to the main price-supported farm commodities. Second, and more importantly, price-fixing that overstimulates domestic production leads to measures to unload our surpluses in foreign markets by methods that are more or less disruptive. In fact, programs for the foreign disposal of our farm surpluses have created serious problems for our diplomats in some friendly countries.

**METHODS OF FOREIGN SURPLUS DISPOSAL**

There are various ways of disposing of surplus farm commodities in foreign markets. Most of them have already been tried. The methods set forth in the Agricultural Trade Development and Assistance Act of 1954 as amended (Public Law 480) illustrate what may be done. Title I of P.L. 480 authorizes the sale of \$3.0 billion of farm surpluses to foreign countries for foreign currencies instead of dollars: to Brazil for cruzeiros, Italy for lire, Peru for soles, Chile for pesos, India for rupees, and so forth. The sale against foreign currencies is designed to make purchases attractive to countries that might be reluctant to use dollars. (Other attractive features are indicated below.) Title II of the Act permits transfers of surpluses on a grant basis (up to \$300 million) to foreign governments in order to provide famine relief and other assistance. Title III permits the disposal of surpluses in domestic school-lunch programs, in distributions to needy persons at home and abroad, and also in bartering for strategic materials.

The sale of farm surpluses against local currencies is of interest. First, it must be recognized that many of such sales are on a long-term loan basis, the loan being payable in local currency. Thus, some sales are on terms payable over as long as 30 years, at relatively low interest rates. In any case, the sales give rise to a supply of foreign currencies. What may the United States do with the resulting foreign currencies? Section 104 of the Act spells out the uses: the funds may be used to help develop foreign markets for our farm products, to acquire strategic commodities for our stockpile, to procure foreign materials and equipment for the common defense, to make grants for foreign economic development, to pay United States obligations to foreigners, to make loans for economic development,<sup>1</sup> and to finance international educational ex-

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<sup>1</sup> Some problems have arisen in connection with attempts to borrow some of the proceeds of Public Law 480 sales. One involves big-name American companies, which have pressured our government to influence the local government in favor of lending some of the proceeds to such companies for their own local expansion. Such lending does not appear to be in the spirit of American legislation, the intention of which is to speed up local development by adding to local resources

change activities. Most of the local currencies have been used in making long-term loans to the surplus-receiving governments so that they might add to their resources for financing their own economic development programs. That is, the countries receiving our farm surpluses pay us by incurring a debt to us, and when we receive payment we will use much if not most of the proceeds to lend back to the countries for financing long-term development. In order not to displace private marketings of our farm products, the sales have been made at 105 per cent of the support price.

The law also contains provisions designed to safeguard against (1) the displacement of usual suppliers of other importing countries, and (2) the undue disruption of world market prices.

Special methods have been used to move surplus stocks of cotton. P.L. 480 sales have included cotton, but such sales of this commodity were depressed because of the level of the price. In consequence, the United States offered to sell its surplus cotton in foreign markets at world prices, which were substantially below domestic support levels. Called "dual pricing," this practice has engendered marked opposition from the governments of foreign cotton exporting countries.

#### **FOREIGN EFFECTS OF THE DISPOSAL PROGRAM**

The program has had both good and bad effects in foreign countries. Consumption of food and fiber has expanded somewhat in a number of countries. This has been notably true in the poorer nations as a result of the introduction of such devices as school-lunch programs as well as through the increased availability for general public consumption of farm commodities that could be purchased for local currency. General economic development in many countries has also been assisted by the use of some of the local currencies that have been received from the sale of surpluses.

for such basic projects as roads, storage facilities, and the like, for which alternative financing may not be available. The American companies have alternative sources of capital at their home base, and it is also lower-cost capital. It would seem to be short-sighted in more than a public-relations sense, given the under-developed countries' concern over the balance of payments burden of servicing foreign investments.

In the case of some of our price-supported products, moreover, the United States has held a price umbrella over the foreign sectors of the industry and has thus facilitated a speedier development of local farm production in many countries. Our cotton policy in particular has had this effect.

The adverse effects, however, appear to have predominated. Though the United States has tried not to disrupt world prices and normal marketings, many of our sales have inevitably caused such disruptions. First, sales against foreign currencies on a long-term repayment basis represent generous terms that many other financially weak, competing export countries are unable to offer. Rival sellers thus feel that they are at a disadvantage. The disadvantage is even greater than indicated by the lengthy payment terms, since in some cases importing countries with multiple exchange rates (including a free market rate) have been able to convert their currencies into dollars, for the purpose of calculating the local currency equivalent of any given dollar value of our sales of farm products, at an exchange rate well below its free market level. For example, Country X may have had three exchange rates, an official rate of, say, 100 units per dollar, a preferential import rate of 200 units, and a free market rate of 300. This country's income and price levels may have been such that the first two rates greatly overvalued the currency. Nevertheless, there are cases on record in which surplus sales have been made at one of the overvalued exchange rates instead of the more proper free market rate. Second, agricultural exports are a bread-and-butter proposition to many other exporting economies, whereas the same exports play a relatively minor role in the over-all economic position of the United States. This is much more important politically than economically. We have been accused, for example, of using aggressive selling tactics unbecoming of a wealthy nation, all because our domestic agricultural price policies have given rise to unwanted production. Third, we openly resorted to dual-pricing in the case of cotton. This action led to a sharp reduction in the world price of this product. It was not the world price reduction *per se* to which other nations objected, since the reduction moved the world



price nearer to a long-run equilibrium level. The real objection was to the magnitude of the cut and especially to the international distribution of the adjustment burden. Specifically, since our high domestic price supports magnified the domestic surplus other exporting countries felt that they were being compelled to sell their output in the world market at a lower price than would have prevailed if the United States support level had not been kept at an artificially high plateau. As a result, all manner of very serious diplomatic complaints were lodged with the State Department by many friendly countries.

What is the root of the matter? It is not the dumping of surpluses but something else: it is the continual production of surpluses. The real solution, therefore, is to stop producing the surpluses. Since domestic agricultural policy is mainly responsible for the surpluses, it is necessary to adopt sensible agricultural price policies. The elimination of the surpluses would have another beneficial effect as far as trade policy is concerned: it would enable the United States to eliminate many restrictions on agricultural imports.

How may the agricultural surpluses be eliminated? This is a big order. In general terms, the objective must be sought by accelerating the movement of resources away from the less productive areas of American agriculture. For this purpose, the main need apart from sound agricultural policies is a strong and expanding nonagricultural sector.

We can expect considerable trouble with our trade policy while we are trying to eliminate the farm surpluses. Nothing illustrates this proposition more clearly than does cotton. Thus, our current cotton export subsidies enables foreign mills to buy cotton at almost a third less than the price that domestic mills have to pay because of our high price supports. Clearly, our cotton textile producers are being handicapped because of grossly objectionable farm policies.

We thus have the classic case of one senseless policy begetting other senseless policies. Specifically, at the time of writing our cotton textile producers were expected to obtain relief in two forms. First, they would be given an export subsidy so as to offset the

raw-material disadvantage under which they labored and which resulted from acts of Congress. Second, they would be given protection against imports in the form of quotas. Cotton policy has indeed given rise to a "chain reaction."

### **THE ESCAPE CLAUSE**

It is easy to exaggerate the inconsistency between the "internationalism" of our trade agreements policy and the "nationalism" of our agricultural policy. This may be indicated by way of a discussion of the escape clause issue, the second of the reactionary or potentially reactionary aspects of contemporary commercial policy which we discuss in this chapter.

Let us first recapitulate. We have seen that our trade agreements contain a provision, called the escape clause, which enables the United States to terminate or modify a specific concession if the working of the concession "causes or threatens serious injury" to a domestic industry. We have also seen that the escape feature, first invoked formally about a decade after the inauguration of the trade agreements program, was destined to be a part of the trade agreements program. That is, an escape feature is more or less implicit in a trade-barrier reduction program because United States government negotiators do not knowingly grant a concession which is expected to injure a domestic industry. From the beginning, then, American industry has had grounds for believing that there would be protection against "unforeseen" developments. In fact, without such assurances it is doubtful whether Congress would have undertaken to renew and extend trade agreements legislation.

### **IMPORTANCE OF THE INJURY ISSUE**

The country's foreign trade is affected by several major forces, one of which is our tariff structure. We are still in the process of reducing tariff barriers to trade. But there is or may be a big obstacle in the path, namely, policy with respect to the injury of domestic industry.

posed of two groups—one favoring a strict construction and infrequent invocation of the clause so that trade may expand and the other advocating a broad interpretation along protectionist lines. Thus far, Commissioners favoring a strict construction have had the upper hand, but this situation may change. Also, Congress may favor a reaction to protection.

If we examine the record, we find that the Commission has required that certain conditions be present before the escape clause will be invoked. All of the following conditions must be satisfied:

1. The product on which a concession has been granted is being imported in increased quantities, absolute or relative to domestic production or consumption.
2. The increase in imports is the result, wholly or in part, of the concession.
3. The increase in imports is causing or threatening serious injury to a domestic industry which produces like or directly competitive products.

Let us discuss these conditions. Before we do, however, it may be pointed out that the first one has involved some differences of opinion among the Commissioners and the second only minor differences. It is the third that has been the source of the most serious disagreements.

The first criterion listed above is that of increased imports. The escape clause uses the present tense, “. . . is . . . being imported. . . .” Decisions that have been made generally construe this to require that the current level of imports be higher or that the current trend be rising. “Trend” as used in this connection means a short-period movement of a year or so. This period is used instead of a time-span of several years or more because the intention of the law is to avoid *any* serious injury.

The second criterion runs in terms of the concession as the cause of increased imports. This has involved little disagreement among the Commissioners, as has already been pointed out.

As we have indicated, it is the third criterion, that of serious injury, which constitutes the most crucial requirement. There are three subparts to this requirement, each of which has produced

strong disagreement within the Commission. The first subpart relates to the nature of serious injury. In making this determination, the law states that ". . . the Tariff Commission, without excluding other factors, shall take into consideration a downward trend of domestic production, employment, prices, profits or wages in the domestic industry concerned, or a decline in sales, an increase in imports, either actual or relative to domestic production, a higher or growing inventory, or a decline in the proportion of the domestic market supplied by domestic producers." It will be noted that the instruction is in broad terms, and nothing is said about the relative importance of the several factors.

The problem of the base period has presented some difficulties. Most of the time, however, the Commissioners have held that (a) the base period should not include years in which abnormal influences, such as war, were at work, and (2) that a recent base period is to be used in preference to a distant one.

An extremely controversial aspect of what constitutes serious injury turns on the law's reference to ". . . a decline in the proportion of the domestic market supplied by domestic producers." In the minority's view a heavy weight should be assigned to this factor, especially when a decline in the share was associated with other weaknesses in the industry. The majority (strict constructionists), however, have not been persuaded to go this far, since this "share doctrine," as it has come to be known, would call for escape-clause action even when the domestic industry was producing more than ever before in absolute terms and earning good profits.

The trend of production and the level of profits are criteria that are worthy of note. In fact, these two together have been key tests of serious injury. In the opinion of the minority, a decline in the use of plant capacity in an industry should be grounds for escape action. The majority have not accepted this view because none of the cases before the Commission involved a declining trend in actual production. As far as profits are concerned, a low ratio of net profits to sales, or the occurrence of losses, has been held to be more important than a declining trend in earnings.

Rising inventories have also been adduced as evidence of serious

injury. But in many of the cases inventories of imported goods were also high. The majority has held that the inventory position of complaining industries was temporary in nature and refused to recommend tariff relief in such cases.

We turn next to the second subpart of the serious injury condition, namely, imports as a cause of such injury. Should the escape clause be invoked if an industry is suffering reverses in a situation in which increased imports had not been a significant factor? The majority has held that imports could not be regarded as the *cause* of serious injury in such a situation. To be a cause, the increased imports must have contributed significantly to the industry's further deterioration. Thus, invocation of the escape clause has been ruled out when decline in an industry is due overwhelmingly to technological developments, to inventory accumulation, or other purely domestic changes.

Finally, we turn to the third subpart of the serious injury condition. This relates to the definition of "the domestic industry producing like or directly competitive products." A big issue has been this: in dealing with production, profits, etc., should the domestic industry be held to include *all* the operations of the firms making up the industry or only those operations that tie in directly with the production of the product that is before the Commission? The majority has held that injury must be established in terms of the over-all operations of the industry. This ruling is important, since most goods produced in the United States are produced by multi-product firms. Thus, if an industry producing goods A, B, C, D, and E claimed tariff relief for product E but continued to make good profits from the production of all five products, the majority has held that a finding of serious injury was unwarranted. The minority, on the other hand, has claimed serious injury because of losses on product E. They feared that the majority's view would virtually nullify the escape clause. Clearly, the minority's position is extreme, since it is difficult to see how an industry whose total business is affected to only a slight degree can be seriously injured by imports. Changing the composition of output and shifting to other fields in such situations are the best means of escape from foreign competition.

As has already been indicated, issues of this type must also be seen in terms of possible reactionary policies that stem from Congress. Unfortunately, the legislature, in the Trade Agreements Extension Act of 1955, has sided in effect with the Commission's minority. We have already cited the particulars. It follows, therefore, that unless the 1955 amendment to the Act is changed, the country is likely to see a lot more escape clause actions than has been shown by the record thus far. The resurgence of protectionism could assume large proportions and place additional obstacles in the path of the President in the execution of a sound over-all foreign policy for the United States.

#### **THE ROLE OF THE PRESIDENT**

The Tariff Commission may recommend that the escape clause be invoked, but the final decision rests with the President. He necessarily applies broader considerations of foreign economic policy, especially the adverse effects of tariff relief on relations with friendly nations—considerations that are beyond the Commission's terms of reference under the law.

Each of the Presidents who has made decisions under the escape clause has taken such broader considerations into account. But in each case in which the President has rejected recommendations of the Tariff Commission the action of the Chief Executive has been based on the ground that the Commission had not established serious injury to his satisfaction, or that the increase in imports was not the major source of the industry's difficulties, as well as upon broader considerations of foreign economic policy.

#### **A SUMMING UP**

Decisions by the Tariff Commission have revealed the following: (1) a drop in output and low profits are the main tests of serious injury; (2) regarding the effects of increased imports on production, profits, and employment, the industry referred to in the law until 1955 comprised the over-all operations of the constituent firms and not one product (among several that are pro-

duced) on which losses may be incurred while an over-all profitable showing has characterized the industry; (3) current increased imports must be a cause of serious injury, and if other factors have also been present the increased imports must have contributed substantially to the further deterioration of the industry; and (4) the base period should be recent but not one in which abnormal influences have been at work.

The President may reject recommendations of the Tariff Commission, either by rejecting the Commission's presentation or by invoking broad considerations of foreign economic policy. In cases thus far involving presidential rejection, the President has not relied solely on the broader considerations.

#### **THE ESCAPE CLAUSE AND THE FUTURE**

Though there are undoubtedly grounds for invoking an escape clause in carefully considered over-all, industry-wide situations, experience has shown that there are several risks of reaction in the operation of such a device. First, a shift in the membership of the Tariff Commission toward a protectionist majority, coupled with a President who showed less concern for freer trade than recent occupants of the office, could give rise to the use of the escape mechanism in a great many cases. Escape-clause applications of the past have not been numerous because it was known that the chance of getting more protection through this route was rather small. Once it becomes known that the chance had improved greatly, many more applications would be filed on behalf of producers by the great number of Washington attorneys who are prepared to do such business. Second, there is a risk that present legislation has undesirable protectionist features or is too vague and prone to a greater protectionist application than seems desirable in the broad national interest. In particular, the escape clause appears to need modification in several respects. For one thing, the application of the clause should not be available to the products of *growing* American industries. The basis for this statement is that it is the capital of business and the jobs of workers that need pro-

tection, on a careful basis, against an injurious increase in imports, not the output of a particular product. For another, as is implied in what has just been said and as has been indicated above, the law should be amended so as to make it clear that the escape clause will not be available to single products but only to industries as a whole. Finally, the law probably should be modified to take into consideration the outward mobility of labor. There is more of a case for giving the benefit of the escape clause to an industry whose labor is highly specialized to that industry, and thus could not easily shift to another industry, than to give it to labor that has many other opportunities for employment.

Once the law is strengthened consistently with the basic purpose of the trade agreements program, which is to expand our trade by means of an increase in imports without really serious and lasting injury to domestic industries, we are likely to see increasing benefits from trade. The uncertainties at present are such that, as Professor Viner has aptly put the matter to a committee of Congress, foreign businessmen "would regard themselves as fools if they were to make a major investment in such things as special designing for the American market, finding out what Americans want, establishing dealer contacts, setting up warehousing facilities, launching advertising campaigns, and expanding their own production facilities abroad in order to develop the American market, as long as they are faced with an imminent threat that if they did succeed the American tariff would be raised against their products."

### ANTI-DUMPING ACTIONS

There is also a risk of lapsing into reactionary commercial policy by still another route. We refer to recent and disturbing evidences of resurging protectionism in the application of the Anti-Dumping Act of 1921.

This Act, as amended, states that there is to be a finding of dumping whenever the Tariff Commission ascertains that a product "is being, or is likely to be, sold in the United States . . . at



less than its fair value" and that "an industry in the United States is being or is likely to be injured" by such imports. However, the Act contains no definition of the key words "fair value," "injury," or "industry." Such definitions and other criteria are left to the discretion of the Tariff Commission. When a finding of dumping has been made, there is to be a dumping duty equal to the difference between the United States purchase price and the foreign market value.

#### **KINDS OF DUMPING**

There are various kinds of dumping. Similarly, there are various motives for dumping. Technically, dumping consists of price discrimination across national boundaries. It is the sale of a product domestically at one price and to foreigners under otherwise similar circumstances at another and lower price. In this connection, it must be borne in mind that cheapness of imports on a stable basis is ordinarily an advantage to the importing country.

We may make a run-down of the leading types of dumping. Sporadic dumping is usually motivated by a desire to dispose of a casual overstock. Innocent dumping may result from a change in price levels while goods are being readied for an order or are in transit. Short-run or intermittent dumping occurs from a desire of foreign producers to maintain a foothold in markets where prices have dropped, to develop goodwill in a new market, or to retaliate against dumping. Long-run or continuous dumping is based on a desire to maintain capacity or larger-scale production without cutting domestic prices. Finally, predatory dumping is that which occurs for the purpose of killing off rival firms. Incidentally, after World War I it was the fear of predatory dumping by giant members of the German chemical industry that was mainly responsible for the passage of the Anti-Dumping Act of 1921.

To see this problem in perspective it may help to be reminded that competing domestic producers usually look upon any form of foreign competition as unfair competition. Hence, alleged foreign dumping may be only a pretext for higher import duties.

What kind of dumping did Congress intend to restrict when it passed the Anti-Dumping Act? A provision in the Revenue Act of 1916 gives a clue. This provision imposed penalties for systematic dumping in the United States with the intent of destroying an American industry. That is, it aimed at predatory dumping. The statute was never used, however, owing to the difficulty of proving the intent of the dumpers. After the war, the fear of dumping for the purpose of injuring "war baby industries" induced Congress to order the Tariff Commission to search for a more effective method of dealing with the problem. The resulting recommendations led to the Anti-Dumping Act of 1921. According to a subsequent statement of the Tariff Commission, the penalty imposed under this Act was not intended to be applied where the price differential is not "accompanied by unfair circumstances or by unfortunate public consequences."

Cases that are not unfair would comprise those on the order of the following: First, sporadic dumping to relieve a casual overstock, since this is the universal practice of the kind that occurs at home when, say, a department store offers "clearance sales." Second, innocent dumping, as described above. Third, price-cutting in one market to meet the competition of that market. This would involve meeting prices following price-cutting by a dominant domestic seller. Incidentally, this is the type of price discrimination that is permitted domestically under the Robinson-Patman Act. It is the other types of dumping against which the Anti-Dumping Act of 1921 was meant to be applied.

#### **RESTRICTIVE EFFECTS**

Since 1934, a total of 165 complaints of dumping have been submitted to the government. Of these, 25 were dismissed because the volume of imports was negligible, 51 because there was no basis for a finding of injury, and 81 because there were no sales at less than "fair value." There were 8 findings of dumping.

There is more to import restriction under the Anti-Dumping Act than these figures suggest. Specifically, it must be emphasized

that the small proportion of findings of dumping does not mean that the protectionist effect of the law is small. This is because the mere act of complaining about dumping to the government restricts imports, even if the government eventually determines that there had been no dumping from the outset. Thus, during the period of government investigation of charges, imports cannot be cleared through customs. Moreover, goods included in a complaint that arrived 120 days prior to the first suspicion of dumping are also denied customs clearance. All appraisals of such goods are also withheld. The result is that importers are unable to determine their costs, find it difficult to set their prices, and in addition they operate under a cloud of possible retroactive penalties. Moreover, unlike escape-clause actions, there is no presidential review under the Anti-Dumping Act. In short, domestic firms have found that complaints lodged under this Act represent one case "where they can win even if they lose." Merely setting the investigative process in motion does the trick.

#### **THE CASTIRON SOIL PIPE CASE**

A recent case that has been decided under the 1921 Act may set a precedent of serious dimensions. The Tariff Commission, in the Castiron Soil Pipe Case of 1955, made a finding of injury with respect to the impact of imports on that part of the industry located in just one state. Clearly, this involved a peculiar definition of an "industry." The firms in this state comprised some 10 per cent by number of the nation's firms in the industry, and they produced about 8 per cent of the country's output of castiron soil pipe. Imports, equal to under four-tenths of 1 per cent of domestic production, did not amount to over 3 per cent of the state's output. Production and prices in the state had been rising. It was found that the decision had been based on the fact that there was one marginal producer in the state. This producer had not been making a profit, and in fact the firm had closed down on three previous occasions within 20 years and had not shown a profitable position even when there had been no imports.

The danger, clearly, is that the decision in this case may give rise to an official doctrine in which an industry with only one marginal producer is entitled to tariff relief by way of the Anti-Dumping Act of 1921. This would be strange doctrine indeed. Unless reversed, there would be hardly any imports that could not be stopped under the law.

It helps to visualize the issue in broader terms. The significance of dumping from the national viewpoint has to do with the question of the stability or instability of cheap imports. If there is short-lived cheapness of imports owing to unfair dumping, we should use anti-dumping measures. In other words, unfair dumping involves prices that are not necessarily cheap in a long-term sense. Incidentally, the United States is said to dump wheat. That is, we sell at high prices at home and offer foreigners bargain prices by domestic standards. In terms of world prices, however, we probably are not exporting wheat at particularly cheap prices.

The wheat case illustrates why it is dangerous to apply dumping duties in a mechanical way. There is danger that we may apply them where there is no clear and genuine injury to an American industry but only to a small wing of a big industry that may be highly prosperous.

### PROBLEMS

1. "Every sector of American agriculture would be better off if our farmers competed for all markets, domestic and foreign, without benefit of price supports or acreage and/or marketing controls." *Evaluate.*

2. "The peace of the world would not be facilitated if wheat-exporting nations generally were to decide to retain the volume of exports they had during their peak periods." *Elaborate.*

3. "There will come a day of reckoning with respect to Public Law 480 sales when we try to use the foreign currencies that have accrued under our surplus disposal program." *Explain.*

4. "The escape clause does not exert a significant restrictive effect on imports as is shown by the fact that in cases of an impending application of the clause imports, instead of declining, actually increase." *Evaluate.*

5. "Ever'since the trade agreements program it has been possible to lower many duties without injuring anyone." *Explain.*

6. "A multiproduct industry, once the United States has made trade agreements concessions, is just as prone to injury from increased imports as any other American industry." *Evaluate.*

7. "The Anti-Dumping Act of 1921, if administered by certain individuals, could make the escape clause look like small potatoes." *Explain.*

8. "One could argue that Public Law 480 sales for the overvalued local currency equivalent of United States support prices constitute real dumping." *Explain.*

## CHAPTER 20

# Western European Regionalism

The unfolding economic changes connected with the integration movement in western Europe are among the outstanding developments of our time. Things are really happening in Europe, but the phenomena are not wholly European: America, with its material aid and advice, has contributed a great deal. What, in general, have been the forces producing the New Europe? In what significant ways does European economic regionalism manifest itself? Are there economic weaknesses in the new developments or sources of conflict in the relations among key members? What does it all mean to United States foreign policy in general and our foreign economic policy in particular?

### THE ORIGINS

Western European regionalism did not spring fully grown just after World War II. Its roots go back for centuries to events and the pronouncements of great historical figures. Indeed, the origins of European unification may be traced to the associations of ancient Greek communities. We also see traces in the evolution of the Roman Empire. Pronouncements on the general theme of an integrated Europe may be found in the fifteenth century in the proposals of the King of Bohemia, in the seventeenth century suggestions from such men as the Duc de Sully, Leibnitz, and Wil-

liam Penn, and in eighteenth century proposals by Rousseau, Bentham, and Kant.

The ideas were not homogeneous. In the Middle Ages the main idea was the need for machinery to eliminate international disputes and maintain the peace. Kant visualized union as the stepping stone to a republic; later writers introduced the notion of disarmament. Thus, earlier versions of the idea stressed political factors. It was not until the nineteenth century that writers and statesmen emphasized the link between political and economic issues, mainly through the movement for free trade.

Unfortunately, little came of these suggestions. The unification achieved was the result of conquest—by Napoleon in the early nineteenth century and by Hitler in the twentieth century.

Why the current revival of interest in European integration? Clearly, the main factor has been the general recognition of the communist menace and the nature of the communist doctrine of revolution. Better to band together for positive action than to risk subversion under old-fashioned nationalism. Thus, this menace has galvanized into action all manner of European groups who cherish free institutions. These Europeans are not just against reactionary communism; they are for various kinds of area-wide economic and political arrangements that promise large common markets, and thus give new scope for free institutions and economic expansion. However, countries in western Europe have not participated in the new movement in a uniform way. A jungle of European organizations has sprouted since the end of World War II. Thus, some countries are for certain phases of the movement while others emphasize other aspects. For example, the Brussels Treaty Organization has five members; the OEEC 18; NATO 15 (including Canada and the United States); the European Coal and Steel Community six; the Council of Europe 15; and the Western European Union seven.

The scope of western European regionalism is so broad that we must perforce limit ourselves to the highlights. Political questions as such fall outside the scope of this book, but our discussion will necessarily throw some light on political matters.

### THE MARSHALL PLAN

Within a few years of the end of the last war it became clear in Washington and in large parts of America that European economic recovery from the war would be more difficult than had been anticipated. The restoration and consolidation of free institutions, necessarily tied to such recovery, hung in the balance. Allied Europe, with whom we struggled together to achieve victory in war and with whom we have had ancient bonds of freedom, could not be left stranded now that every effort was bent on "winning the peace."

During the war, the United States was the "arsenal of democracy," and the institution of "lend-lease" the mechanism by which we made grants of military items and other essential goods to our allies. Lend-lease was terminated at the end of hostilities. Europe was on her own. But difficulties appeared almost immediately. This was evidenced by Britain's situation in 1946 necessitating it to call for a \$3.75 billion loan from the United States. But it was soon clear that this loan, or others like it, were not enough. A year later Secretary of State Marshall, wartime chairman of the Joint Chiefs of Staff, made a historical announcement at Harvard. America, he said, had decided to devote some of its resources on a grant basis to speed up Europe's economic recovery and hasten the advent of a politically strong free Europe. This was the Marshall Plan, envisaged as an operation that would require some four years. Europe's economic recovery not only was accomplished within the suggested original framework, but the result was achieved on schedule. In the process, the free world was given an object lesson of the vigor with which Western nations may develop economically and enrich consumption while the communist states push ahead under the burden of top-heavy controls and the deprivation of liberty without paying much attention to the consumer and the job preferences of workers.

The Marshall Plan's original framework involved new institutions on both sides of the Atlantic, to which we have already re-



ferred briefly in a previous chapter. On this side, we set up the Economic Cooperation Administration (ECA), headed by a distinguished businessman. In response to our request that Europe establish its own intergovernmental apparatus for the promotion of economic cooperation (in the very initial stage, to allocate American aid), the countries of Europe devised the now-celebrated OEEC—the Organization for European Economic Cooperation, with headquarters in Paris.

ECA promptly established liaison with the European countries by setting up "country missions," staffed with specialists and located in the capital of each European member of the OEEC. These missions worked closely with the host governments, helping to chart recovery courses while bearing in mind that each country's recovery effort should dovetail with that of every other European nation. Simultaneously, ECA's headquarters organization was established in Washington, with area and commodity specialists. The job was to cooperate in the formulation of recovery programs for individual European states, tailored to the circumstances of each country. Imports required for recovery, screened and approved in Washington, were in excess of the ability of each country to finance from current export proceeds plus other funds then available to them. This excess measured the deficiency of resources that America promised to make good, by picking up the bill in the form of grant aid. The ECA "team" worked with missionary zeal. In fact, the quality of the personnel and the spirit and tempo of work were such as to amaze all who were familiar with the operations of run-of-the-mill bureaucracy.

Europe's OEEC in many ways has been even more remarkable. We must know a few details of the OEEC before we can appreciate the role of the Marshall Plan. Though the details are provided below, we may say this in the present context: The meaning of the Marshall Plan is not to be found in lessons with respect to the administration of a unique foreign aid program. Rather, it is to be found (1) in the depth of the cooperation among sovereign states that was prompted by American aid and (2) in the revival of confidence and optimism in western Europe which was care-

fully nurtured under the aegis of our aid. The OEEC more than anything else is the living symbol of the Marshall Plan. Briefly, it is the European organization which turned 17 national aid programs into one, broke the shackles of Europe's bilateral trade, and provided a flexible and novel cooperative approach to Europe's economic problems. One has only to remember the EPU, the OEEC's most imaginative and important achievement, to find an illustration of what is meant. While the ECA passed into history near the end of the four-year Marshall Plan period, a quasi-successor agency is still in being, providing aid mainly of a military kind largely to areas outside Europe.

### HIGHLIGHTS OF THE OEEC

Organizationally, the OEEC consists of a Council, which makes all major decisions but meets only infrequently, an Executive Committee which meets weekly to assist the Council, and several key units as well as a number of committees, commissions, and working parties. The key units are the Ministerial Committee for Agriculture and Food, which seeks to integrate European efforts to expand agricultural output, the Managing Board of the EPU, the Steering Board for Trade, which is mainly concerned with quota liberalization—but does virtually nothing about tariffs, and the European Productivity Agency, an area-wide organization which seeks to expand output per hour. There are also more specialized committees, such as a Coal Committee, one on Oil, another on Timber, and still others dealing with problems of European electricity, iron and steel, chemicals, and the like. A secretary general, who has been a Frenchman from the beginning, coordinates the work of an international secretariat, prepares the meetings of the Council, and executes this body's decisions.

What are some of the typical operations of this international apparatus? When coal was in short supply during the Korean conflict, the organization was used to coordinate requirements and scheduling, to most efficiently use scarce ships needed to move coal from America to Europe. In important instances, the OEEC ap-

paratus was used to induce some countries with relatively good supplies to share them with neighbors, generally by diverting tonnage afloat from the former to the latter. When oil became scarce in Europe owing to the blockade of the Suez Canal, the OEEC again acted as the coordinating agency to assure an equitable distribution of available supplies. In the case of European energy problems, a special committee made a careful survey of energy resources in western Europe. This in turn led to the Organization's specific proposals for producing nuclear power on an area-wide cooperative basis. Valuable studies have also been made of methods of integrating national policies with respect to agricultural production so as to minimize the area's dependence on the least efficient sectors of European agriculture. This work involves many difficulties, which it is hoped will be surmounted stage by stage. We may also consider the role of the OEEC with respect to economic development programs in some of the lower-income members of the Organization. A committee was established to see what the Organization could do to help Italy carry out its ten-year development program to increase output and raise levels of living in the southern part of that country. The resulting document was not put on the shelf to gather dust. It became the basis of an approach to the EPU, which is a part of the OEEC apparatus. Within a short while the EPU offered financial help in the form of a special \$50 million term credit to Italy, so that it could incur a trade deficit with the other members of the Union in order to finance imports of capital goods needed to accelerate the development program. The OEEC thus became a part of the machinery by which Italian investment targets were met.

#### **THE ANNUAL REVIEW**

Let us now refer to a key operation of the OEEC—the Annual Review, preparation of which is a year-long operation. This is the exercise in which each country presents a report on its own economic situation and prospects, highlights major economic policies that are in force or under consideration, and submits to a

systematic cross-examination by other members. For example, an examining team of, say, France, Norway, and Italy may examine the United States submission, critically questioning the American representatives whose case has been presented after elaborate work in Washington and double-checking with every embassy located in the OEEC list of nations. What are the soft spots in the American economy? Are there inconsistencies in policies and performance? A recession is to be guarded against since it will have an unfavorable impact on Europe's exports and dollar earnings. If there is objective evidence to support the thesis that a recession is impending, the United States representatives are asked what the government intends to do. Similarly, if France's submission is being examined by a team consisting of, say, Belgium, Germany, and the United States, and serious inflation is indicated, France is grilled about the steps that are being taken or planned to deal with such an inflation. Thus, there is collective self-analysis. Other OEEC countries are concerned with national problems of the indicated kind because they usually portend the adoption of restrictive trade barriers (or a slowing down in the relaxation of such barriers), which harm the export business of other members of the Organization and thus imperil a segment of Europe's economy, or they weaken the economy's ability to support its share of an adequate European defense posture.

#### **NATO AND ECONOMICS**

The matter of defense leads us to discuss the relation between the OEEC and the economic wing of NATO, the North Atlantic Treaty Organization, which is also quartered in Paris. The OEEC includes several neutral nations—Austria, Sweden, and Switzerland. Should NATO duplicate the OEEC's work because of the presence of neutrals in the latter organization? This issue arose some years ago and was decided in the negative. Instead, an informal arrangement was reached whereby the OEEC does the basic work on European economic problems, except work tied closely with military data and estimates which are secret and thus

not submitted to the body which contains neutral members. Moreover, the same men as a rule represent their governments in the economic work of NATO and the regular work of the OEEC. The result is that a maximum of efficiency is achieved in the economics area in the use of personnel and facilities.

The annual review work of the OEEC is timed so that it usually terminates on the eve of discussions by NATO's own annual review committee, which is mainly concerned with such matters as defense expenditures and military production. This coordination helps to expedite NATO work. In particular, the OEEC's work helps to clarify matters and to facilitate the adoption of programs falling within the scope of Article II of NATO, which requires the members of the alliance to cooperate to achieve non-military objectives as well as those purely military.

The cooperation between OEEC and NATO is exemplified by the developments during the NATO annual review. This operation has been characterized as one showing that the countries are not only in the same basket but that they are in the same omelette. NATO is a continuous combined planning organization involving countries using common military equipment, pipelines, and so forth. The annual review is the means by which the program is evolved. It first assesses the nature of the external threat; then on purely military grounds it decides requirements in terms of forces and equipment; after which it considers how these may be met. This is a difficult stage, since military commanders usually want more than is politically feasible in peacetime. In short, this is the stage in which countries usually find it necessary to scale down requirements in view of other economic and political pressures on national budgets. Implicated is the delicate matter of deciding what each country is to contribute in men, money, and material—here OEEC's work is most useful. This complex effort is time-consuming; when one year's job is finished, it usually is necessary to start the next annual review.

While on the general subject of the military aspects of European economic regionalism, we may mention another interesting activity. Use has also been made of a formal multicountry approach to the

coordination of export policy involving strategic goods which the Soviet bloc nations would like to import from the West, thus accelerating the military build-up of the communist area. This work, in which the United States participates formally, is not a part of either the OEEC or NATO. Instead, a separate Coordinating Committee, known as COCOM,<sup>1</sup> meets in Paris to exchange information and to enforce the ban on an agreed list of specified export products. All of the NATO countries participate in this work, details of which are secret.

Speaking broadly, what does the work of the OEEC and NATO really amount to? It is this: a radical change has taken place in the business of international relations. All kinds of economic problems, which not long ago were jealously guarded national prerogatives, now form the daily grist of OEEC and NATO. There has developed healthy habit of cooperation. In some cases OEEC support, for example, has been helpful to governments wishing to take unpopular steps. Italy is a case in point. Positions taken by the OEEC and duly publicized have assisted Italy in slowing down the rise of consumption and increasing savings at a time when programs of investment were at a critical stage.

The accomplishments in the field of payments have already been discussed in our treatment of the EPU. Praiseworthy results have been achieved. But the payments case illustrates that improvement in a given field does not carry Europe automatically to a new and higher, but static, level of accomplishment. A true world trading system is the goal of the European countries, an objective shared with the United States. Once such a global system is re-established, however, there will have to be a big tapering off in the OEEC's preoccupation with payments. In some spheres of regionalism, therefore, activities will have to wither away if the world is not to stop short of the most desirable goals. Tariff issues, which have not been systematically dealt with by the OEEC, should then continue to be scrutinized within the framework of the General Agreement on Tariffs and Trade.

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<sup>1</sup> *East-West Trade*, Hearings before the Subcommittee on Foreign Economic Policy of the House Committee on Foreign Affairs, Washington, D. C., 1954.

### THE COAL AND STEEL COMMUNITY: "SUPRANATIONALISM"

Thus far we have discussed important measures of economic cooperation among sovereign states. European regionalism, however, has also evolved something different. It has given us arrangements in the nature of a new federal system which are often called supra-national organizations. There are several of these, a leading case being that of the European Coal and Steel Community (CSC).<sup>2</sup>

The CSC reflects a substantial measure of disillusionment in Europe with customs unions and the OEEC approach to common economic problems. This institution, which consists of six members (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands) and which began operations in 1953, was conceived as the "first step in the unification of Europe." The Treaty itself contains only a few clauses which refer directly to coal and steel: the bulk of the provisions could be applied to other industries without modification. In fact, what distinguishes the Community is that it is a new form of institution with a new type of constitutional law. The coal and steel industries admittedly are big—they account for well over 10 per cent of the industrial production of the member countries, and so are significant in their own right. Important as are the two basic industries themselves, however, this fact does not explain the real import of the CSC. This lies in the form of its institutions and its potentialities of development.

#### OBJECTIVE

What is the economic objective of the CSC? It is basically simple: to create and maintain a free market for coal and steel

<sup>2</sup> In the available space we cannot go into the details of each of the separate supranational arrangements that have evolved since the war. For example, we shall omit consideration of the customs union that is being attempted in Belgium, the Netherlands, and Luxembourg (called Benelux). This has had only a limited success. A good summary statement is to be found, for example, in Robertson, W., "Benelux and the Problems of Economic Integration," *Oxford Economic Papers*, February, 1956.

within the territories of the six nations. A free market in turn requires that a number of things be accomplished. Tariffs and quotas affecting the industries must be removed. All forms of price discrimination have to be eliminated, including discrimination in transport. And all restrictive (or cartel) agreements among producers must be removed. It is possible, of course, to state the objectives in simple terms. But the CSC's task is far from a simple one. Each country at the outset had complex tariffs and quotas and its own discriminatory pricing systems to assist producers or consumers; transport discrimination in coal and steel abounded; and the two industries had long been involved in cartel arrangements.

The job of the Community is to change all these things so that a common European market may be achieved in coal and steel but, as has already been indicated, this is not the essential feature of the CSC. The main feature is the transfer of sovereignty from national governments to the institutions of the Community.

#### **KEY INSTITUTIONS**

There are four parts to the organization of the Community. First, there is the High Authority, which is to establish and maintain the common market. It acts without first obtaining the approval of the member governments, and its decisions directly bind firms in member states. It can enforce decisions by imposing fines on disobedient firms, and it can inspect the books of all companies in the two industries. Financing of CSC operations is by way of a supra-national tax of not over 1 per cent on the annual turnover of the firms.

The High Authority is responsible not to member governments but to the Common Assembly and the Council of Ministers. The former consists of 78 members, elected by the legislators of member states. The job of the Assembly is to consider the annual report of the Authority and to keep an eye on this body: it may remove the Authority on a vote of censure with a two-thirds majority.

The third part, the Council of Ministers, has the task of har-



monizing national policies with that of the Community. The Authority is required to consult the Council in many matters but it is not required to carry out advice from the latter. Actually, the Council has grown in importance relative to the High Authority as over-all national issues have arisen—such as those in investment, transportation, and problems of market organization—that involve economic questions beyond the Authority's powers. In practice, there is more cooperation between the two than is suggested by the Treaty's language about consultation on the part of the High Authority.

Finally, there is a Court of Justice consisting of seven judges with power to say whether decisions of the High Authority are valid in the light of the provisions of the Treaty which established the Community. Firms and member governments may appeal to the Court.

#### **THE COMMON MARKET**

The six countries started on the road to the common market by abolishing tariffs and quotas on coal, iron ore, scrap iron, and steel in early 1953. At about the same time the CSC obtained a GATT waiver so that it could be recognized as a single contracting party—that is, so that removal of trade restrictions within the Community need not be extended to other countries. The OEEC was also notified that the CSC was establishing a customs union within the code of liberalization of the former body.

Discriminations in transportation rates on coal and steel were also attacked at the same time. But they were only reduced, not eliminated. For example, the CSC set about to cut the discriminations inherent in freight rates that were higher for Lorraine ore going to Belgium than that which moved within France. Similarly, it was necessary to attack the system under which rates for Ruhr coal were higher on export shipments to Lorraine than for internal movements within Germany.

Nothing was done in the initial stage about "split" freight rates, namely, those on traffic crossing national boundaries. The practice

had long been to regard a freight car crossing the frontier as having started a new journey for rate-making purposes. Rates thus reflected imaginary terminal charges on each side of the frontier and took no account of long-haul economies that were really present in traffic on a single journey. These split rates were not abolished until 1955.

Moreover, very little was done at first to reform pricing practices. Most countries had complex price systems, partly industry-fixed and partly government-fixed. Prices were favorable to local buyers, and unfavorable to foreigners in most cases. The CSC did not wish to cause big shifts in the patterns of production and consumption. Hence, it proceeded gradually to eradicate price discriminations. For instance, premium export prices were abolished, as were a few subsidies on high-cost domestic coal. However, the CSC introduced some subsidies of its own, for example, to "equalize" the position of high-cost Belgian coal by imposing a levy on low-cost German and Dutch mines and using the proceeds to subsidize Belgian producers. But these are temporary measures. The Authority has the power to fix maximum and minimum prices, but it prefers to follow a different route: it prefers to create the *conditions* in which prices will be competitively determined.

#### DEVELOPMENT POWERS

High-cost producers will be squeezed hard when a free or common market is fully established—unless the firms in question are modernized or otherwise made efficient by new investment. In any event, shifts of production will probably be inevitable in many cases by the time a common market is in full operation. The position of some coal mines in Belgium and Italy (Sardinia) illustrate what is meant. Hence, the CSC must concern itself with practical problems of long-term development. What are its powers? It is able in some cases to influence the level and direction of investment in coal and steel. Most importantly, it can prohibit the carrying out of investment plans which require subsidies or discriminations outlawed by the Treaty. It may also provide investment funds (a part of which originated with an American loan of \$100 million), and

give opinions on investment plans. Programs with respect to investment will not be easy, especially since the programming is for a free market. In fact, critical tests still lie ahead.

The CSC also has powers to assist labor in coal and steel. Some of this labor may be displaced as shifts occur in the location of industry. In other cases, it will be necessary to encourage labor mobility. The Authority has taken action along several lines, one of which has been to finance housing so as to facilitate transfer of workers, say, of Italians who move outside their country, or of Frenchmen who move from high-cost coal fields in the south to low-cost fields in the north. The CSC is also engaged in retraining programs. It is even expected that the Community will devise a European passport for coal and steel workers.

#### **CARTELS**

In the beginning some observers labeled the CSC as a giant cartel. But the Authority views things differently: it regards its job as one in which monopolies in coal and steel are to be eliminated. The head of the Community, for example, has described the Treaty as "Europe's first major anti-trust law."

Specifically, the Treaty prohibits any "restrictive practices tending toward the division or the exploitation of the market." This is another feature of the power over firms that may be exercised by a supranational authority. Mergers must first be authorized by the High Authority, and none will be approved if the effect will be to restrict competition or otherwise impede the common market. It will not be easy to implement this criterion—any more than it has been easy to ban restraints of trade under our own anti-trust laws. In contrast to mergers, cartels are to be banned unless they can prove that they will lead to an increase of efficiency and will not limit competition. Acting under this authority, the CSC opposed a coal-selling organization in Germany, and in Luxembourg a national coal import office, which the Authority held to be a monopoly, was abolished. Finally, we may mention a history-making action in

1956, when Ruhr coal prices were freed of control for the first time in over 50 years.

The CSC even operates as a medium through which strictly national differences are settled. For example, the German mine-owners went to the CSC to ask for an increase in price. At the same time, the German Ministry of Economics appealed to the same body to deny the request of the owners.

#### ACCOMPLISHMENTS

After several years of operation the CSC could point to a good record of achievement, especially with respect to actions in behalf of the common market. First, it had laid the groundwork for establishing a free competitive market for coal and steel and taken a number of positive actions looking toward the achievement of that result. Second, the record vindicates the federal approach, or the supranational organization, as a method of attaining a limited objective. Third, the CSC has not only dealt with coal and steel, but has stimulated change all around these key industries, as its work in transportation indicates. Fourth, the experience has encouraged the six nations to seek broader objectives. Treaties in 1957 established (1) "Euratom" in nuclear power and (2) a common market for *all* goods. Compared with the CSC, the new treaties give more power to the Council of Ministers than to the federal authorities.

Speaking more generally, the CSC well illustrates a significant new development in international economic affairs. It has shifted the burden of proof in the disputed field of international measures for achieving agreed economic objectives. Concretely, because of the experience under the Community, the burden of proof is now on those who want to interfere with the operations of the common market. This is in distinct contrast to the pre-CSC situation, when each step toward the creation of competitive markets within Europe was the subject of prolonged inter-governmental negotiations.

But there are also some negative factors to report or questions to

raise. First, will the common market meet the test of a major decline in economic activity? Or will such a situation see the breakdown of the Community as nations have recourse to national protective measures? Second, will the CSC foster competition within the six countries but behave as a cartel against outside nations? The risk seems remote, but we must not lose sight of the possibility.

Third, the CSC illustrates the questionable "sector approach." Can the members integrate the two sectors of coal and steel of the economies of six highly industrialized nations while leaving other sectors of economic life untouched? The Dutch, for example, have gone on record in the negative, and have pleaded for a full customs union. Thus, they have argued that policy with respect to modernization of the Community's coal mines cannot be established independently of plans being made for other sources of power. Ruhr coal competes with oil as directly as with coal from Lorraine. Why one set of rules for those who sell coal and another for their main competitors? To the Dutch the sector approach is both the hard way and the economically unsound way of achieving "integration." Others, however, have held that the CSC has been successful mainly because it is limited in scope. This has meant only a limited transfer of national sovereignty, and only marginal adjustments in national economic activities. Now that the device has been extended to other fields, problems may arise about the extent to which sovereignty may successfully be transferred. As has been indicated above respecting Euratom and the all-commodity common market, integration is to proceed by increasing the power of the national governments in relation to the federal authorities.

### **A EUROPEAN FREE TRADE AREA**

Perhaps the greatest effort in European regionalism is the movement to make a free trade zone of most of the area. Such a movement follows logically from OEEC efforts to liberalize trade; no less important, the movement has received strong support from CSC countries' work toward a common market. If the goal of a free trade

area is achieved, it will mark a new era in Europe's economic, and perhaps also in its political, history.

As CSC efforts have begun to show with respect to steel and coal, a wider free market opens up great possibilities for small countries. New industrial methods and sources of power give best results only in large economic units such as are common in the United States. This fact is becoming increasingly recognized in Europe.

Though the CSC countries have led the way thus far, the biggest single development has been Britain's cautious support of the European free trade idea. With the CSC countries, plus Britain, Scandinavia, Switzerland, and Austria, the area would have some 240 million customers. Such an area would be second in economic size only to the United States.

European free trade would be realized in stages. And special arrangements would be made for some members, especially Britain. A major problem with Britain has always been her special trade relations with the Commonwealth. Agricultural products are the main items in which Britain grants preferences to Commonwealth producers. At this writing, it appears that Continental Europe will agree to the exclusion of farm products from free trade, to meet the British problem as well as to enable each country to protect its own farmers.

Major problems will present themselves with respect to the adjustment of tariff rates, quotas, and the like. Tariff rates on manufactures are lowest in the Benelux countries, generally falling within the 8-12 per cent range, somewhat higher in Germany (largely within a 10-15 per cent range), and highest in Italy, France, and Britain (at roughly twice the Benelux level). The CSC countries have proposed that tariffs within the area should be eliminated within 12 to 15 years, according to a prearranged schedule. In order not to have tariff reductions nullified by quotas, the thinking is to have quotas increased year by year by 20 per cent of the preceding quota. Escape clauses as such have yet to be mentioned; instead, suggestions have been made to deal with strategic industries by the use of subsidies and with factor immobility by the use of a

special investment fund that would finance the movement of high-cost resources into other fields of manufacture.

Though only the broad outlines of European free trade are now visible, the prospects of such a development have never looked brighter. Hard negotiations will be necessary, of course, before concrete results can be expected. But the benefits of a wider market in manufactures are likely to prove to be the force that will remove obstacles in the path.

### PROBLEMS

1. "Marshall aid did little more than finance industries in competing countries and thus will go down in history as a big factor working against America's own long-term prosperity." *Evaluate.*

2. "In the conditions left by the war, the North Americans and western Europeans had a vivid consciousness of the values and institutions they wished to defend." *Explain.*

3. "The OEEC converted 17 national aid programs into one." *Explain.*

4. "There is hope that new forms of regional organization will remove the nationalist rivalries that led to war in the past." *Evaluate.*

5. "In the Atlantic Community the United States position is that of *primus inter pares* or first among equals." *Explain.*

6. "It is doubtful whether European economic cooperation within the OEEC could have been as extensive as it has been if the member countries had not all had relatively advanced economies." *Explain.*

7. "It is in the annual review of defense plans and budgets that governments become most conscious of their interdependence and of each NATO member's rights to have views about what another is doing." *Explain.*

8. "If NATO did not exist the relationship between most of its members and the United States—Britain, perhaps, excepted—would be a satellite one." *Evaluate.*

9. "The future of Atlantic cooperation in the NATO form depends overwhelmingly on American willingness to accept restraints in its foreign policy such as no world power has accepted in the past." *Explain.*

10. "Functional cooperation of regional groups of nations is merely dictated by the circumstances of the postwar world and its ideological

rivalries, and especially by the universal demand for peace, prosperity, and fair shares not only between classes but also between nations." *Evaluate.*

11. "A danger of European regionalism is that it may perpetuate discrimination against the dollar area in the name of maintaining regional economic stability." *Evaluate.*

12. "The OEEC may be a symbol of freer trade in Europe, but it has yet to do much to strike at European tariffs." *Explain.*

13. "Though the Soviets do not participate in the OEEC and are unsympathetic with its general aims, they are sympathetic to all European groups and factions that wish to perpetuate systematic discrimination against the dollar area." *Explain.*

14. "The Coal and Steel Community shows the weakness of the sector approach to regional integration." *Explain.*

15. "Universal free trade would make regional integration pale into insignificance." *Evaluate.*

16. "How can the CSC succeed under the conditions of a true common market when the cost of producing a ton of coal in Holland is only half of that in France?" *Evaluate.*

17. "The common market is a notion with a mystical flavor in the inner circles of the CSC." *Evaluate.*

18. "The spokesmen for the CSC fail to note that unbridled competition, to which the Community is committed, is incompatible with economic stability and stability of employment." *Evaluate.*

19. "The experience of the European Coal and Steel Community shows that the opening of frontiers does not so much kill off marginal firms as encourage most firms to reorganize to exploit a wider market." *Explain.*





## State Trading

State trading, the field of large-scale foreign trade operations by governments, is a topic of seemingly increasing importance in commercial policy affairs. All of the international trade of the Communist Empire falls in this category, and the free world appears destined to face more and more state-trading problems as Moscow and Company exploit the potentialities of their trading system for disturbing markets in free-enterprise countries. In the free world itself, there is a surprising amount of state trade, particularly in agricultural commodities—the area that has traditionally epitomized individual enterprise on the production front in most parts of the world. Even the United States is engaged in more state trading than most citizens realize, mainly in surplus farm products.

We shall first discuss the Soviet Union's foreign trade monopoly and the problems posed for the free world by such a trading system. We shall then treat the non-Soviet types of state trading. Wherever possible, there will be discussion of defenses against the worst features of government foreign trade operations.

### THE SOVIET FOREIGN TRADE MONOPOLY: ITS STRUCTURE

Before the last war Russia ordinarily did only somewhat more foreign trade than New Zealand, whose population was less than 1 per cent of that of the Soviet Union. The war has given a great impetus to Soviet foreign trade, which is carried on not only with Russia's satellite countries in eastern Europe and with China but also with other countries.

Foreign trade control originates with the Ministry of Foreign Trade, a department of the government comparable to one of our own executive departments. Below the Ministry of Foreign Trade are numerous Soviet trading *combines*, as they are commonly called, which carry out the actual operations of exporting and importing. Each trading combine (named after the kind of commodity with which they deal, such as Tractor Combine, Lumber Combine, and so on) is represented abroad either by a trade delegation (as in France) or by a special corporation set up according to the laws of the specific country (as in the United States). The Amtorg Trading Corporation is the only Soviet purchasing and selling agency (except for such small things as books and music) in the United States. (The term *Amtorg* is the Russian abbreviation of *Amerikanskaia torgovlia*, which means *American trade*.) Amtorg, which was incorporated under the laws of the State of New York in 1924, is typical of Soviet trading agencies located abroad. It is staffed with marketing specialists and technicians, such as engineers. But Amtorg is able to carry out only those assignments that are specifically given to it by the trading combine in the Soviet Union. That is, as an agent it can do no more than act for its principal in Moscow.

The Ministry of Foreign Trade controls external trade by the simple device of licensing exports and imports. Since the Soviet Union is a planned economy, the Foreign Trade Ministry does not operate independently of the central plan. Rather the over-all import and export program is formulated in advance each year by the central State Planning Commission, which tries to balance Soviet imports with expected exports. Expected imports and exports are thus geared into the whole complex of Soviet planned production. But there are important, and probably increasing, exceptions to the rule: the Soviets may buy and sell in particular national markets to achieve a political objective. We shall elaborate below. Given the planned import and export program, the Ministry of Foreign Trade, by licensing imports and exports, permits the trading combines to carry out their own foreign operations. Such, in brief, is the structure of the Soviet foreign-trade monopoly.

**HISTORICAL SKETCH OF SOVIET FOREIGN TRADE**

The foreign trade monopoly, established by decree on April 22, 1918, is one of the oldest of existing Soviet institutions. At the time of its birth, however, the monopoly was little more than a paper institution, since Russian foreign trade was then all but non-existent. A number of factors were responsible for this lack of trade. Among them were the civil war and inflation, the Allied blockade of the Soviets until 1920, uncertainty as to the international status of the Soviet Union, and the question of repudiated public debt and the seizure of alien property.

The resumption of imports on a modest scale in 1920 enabled the foreign trade monopoly to come to life. But its activity was very limited in scope, and a new change occurred when the period of *war communism* came to an end during the following year. The government retreated from the policy of complete socialization to permit the partial resumption of free enterprise. This new status was known as the New Economic Policy, or NEP. Private production was permitted in minor lines, but key industries and banks were maintained as completely socialized segments of the Soviet economy.

The strength of the foreign trade monopoly was materially diluted during the period of NEP. Although the monopoly shell was preserved, in substance much of the trade was conducted through decentralized channels. Both consumers' and agricultural co-operatives resumed pre-Soviet foreign contacts, and began to carry on trading operations. Mixed companies, in which the Soviet Government contributed half of the capital and foreign private entities supplied the remainder, were also employed in foreign trade. It was by such means as these that a beginning was made in rebuilding the country's trade relations with the outside world. This early period represented government regulation, rather than operation, of foreign trade.

But the formal system of trade monopoly was not abandoned during this period, although there was some pressure from within the government to do so. Some officials wished to replace the

monopoly by a system of protective tariffs. The dominant view, however, was that tariffs would not provide the degree of protection deemed necessary to assure the growth of domestic industries. The official fear was that foreign subsidies and the dumping of products at prices below cost might be used to jeopardize nascent industries. It was decided, therefore, that only a system of centralized and planned licensing of imports and exports would meet the needs of trading within the framework of the Soviet economy. Besides, the foreign trade monopoly would assure that there would be no undue extension of free enterprise in the trading field.

When NEP came to a close in 1928, the planned economy was ushered in in full strength, and the foreign trade monopoly assumed new stature as an integral part of the Soviet economy. Decentralization was eliminated. The government now conducted all foreign trade through the specialized instrument of the trading combine. Centralization and specialization were thus merged into the trading system, which has remained substantially unchanged to this day.

#### **SOVIET STATE TRADING AND NONDISCRIMINATORY TREATMENT**

Charges of Soviet dumping in 1930 and 1931, at the outset of the world depression, led to inquiries concerning, among other things, the guarantees that could be obtained, through international agreement against discriminatory treatment by a state trade monopoly. Soviet representatives assured a League of Nations committee that their purchases and sales were made according to a general plan and were guided solely by the commercial principle of "buying (and selling) in the market which happened to be the most advantageous in each particular case."

Before we consider the implications of this statement, let us touch upon two aspects of the concept of discrimination. In the literature of international economics, this concept is used in two senses. First, there is the sense in which it relates to trade barriers: one or more countries are treated more favorably than all the rest with respect to tariffs, quotas, exchange control, and so on. Second,

the concept has a customary usage with regard to monopolistic practices: The same commodity is sold at one price to some purchasers and at a higher or lower price, or set of prices, to other purchasers. Now, if the discrimination concept is borne in mind and if a country's good faith is not taken wholly for granted, we may obtain a clearer conception of the character of the Soviet pledge of nondiscrimination.

A nondiscrimination pledge made by a state holding a trade monopoly is very different from the pledge made by a government whose foreign trade is wholly in private hands. The reason for this is that when state monopoly violates such a pledge, the countries discriminated against are not in a position to demonstrate that such violation did occur or even that it exists. Under the Soviet rule of "buying in the market which happened to be the most advantageous in each particular case," the best results are obtained by the most skillful practice of discriminating monopsony (that is, discrimination by a buyer's monopoly). We may describe discriminating monopsony by comparing it with competitive behavior. In the case of competition, the trader would buy only in whatever market happened to have the lowest prices, and his behavior, along with that of others, would tend to equalize prices in different markets. A discriminating monopsonist, however, will make price offers which vary with the elasticity of supply in different markets. If a market is characterized by a relatively high elasticity of supply—that is, if the supply is readily expandable—the monopsonist will buy at higher prices than in markets with inelastic supplies. In the case of an elastic supply, a low price offer will lead to a relatively large reduction in the quantity of the commodity offered for sale, whereas the same price offer in a market characterized by inelastic supply will enable the buyer to purchase only a slightly smaller quantity than a higher price offer. The discriminating monopsonist, therefore, will adjust his price offers to the "least his different sellers will accept," and instead of seeking to equalize prices in different markets, he will seek to equalize his net additional expenditures for additional units of purchase after allowing for the effects of his purchases on prices in different markets. (The equalization of

net additional [or marginal] expenditures after allowing for the effects of purchases on price means that purchases in each of the foreign markets will be carried to the point at which the last unit bought in each market involves the same outlay to the monopsonist.) The result of this action will be that the monopsonist's average purchase price will be below the level that would obtain if the goods were sold in a competitive market.

A similar result will be obtained if the state trade monopoly operates as a discriminating monopolist. Lower prices will be charged in markets of elastic demand, since lower prices result in substantially increasing sales; and higher prices will be charged in markets of inelastic demand, where buyers are less sensitive to price changes. In the market of elastic demand, there will be a small divergence between price and marginal revenue, whereas in the market of inelastic demand, there will be a greater spread between price and marginal revenue. However, since the discriminating monopolist will maximize his profits by equating marginal cost to marginal revenue in both markets, it follows that price will be lower in the elastic-demand market than in the inelastic-demand market.

The significance of this brief discussion of discriminating monopoly and monopsony is that a country's adherence to commercial principles is perfectly consistent with a system of trading by price discrimination.

### **USING TRADE FOR NUISANCE-MAKING OR WORSE**

Communist trading methods can no more be shoehorned into a set of Western-style definitions than the Kremlin's political moves can be understood by applying the rules that govern on the banks of the Potomac. It is important that this be appreciated. The Communist Empire is expanding economically and the structure of its trade is changing. Though, as a result of decades of belt-tightening, there is a growing capacity to meet the more modest needs of their own consumers, the communist masters are likely to continue to concentrate on heavy industry and the military at home and to divert some production—over and above that required to pay for

minimal imports—to foreign trade channels so as to attain essentially political purposes. State-operated foreign trade is well suited to such uses. Because state trading organizations are capable of financing sustained losses in foreign sales, if a political objective can thus be reached, they may easily wreck any market that they are budgeted to enter. In fact, one of the threats to the free world's trading system lies in Moscow's ability to launch a concerted attack on parts of the system. This threat may be expected to increase as the Communist Empire's over-all production expands.

Various tactics may be employed to implement communist strategy, which is to attack when and where there is a reasonable chance of success. This means that the United States itself is unlikely to be directly involved. But many other parts of the free world are vulnerable. If these parts find themselves with unsalable export surpluses, they may learn that Moscow entertains elaborate plans for buying them. It matters not that previous Soviet boasts had failed to materialize, or that Russia may not normally use much of the products in question. If some weaker member of the free world is seeking a large-scale loan from the United States and protracted negotiations are involved, the Soviets may promise to provide the capital promptly if only the applicant country will give up any hope of dealing with the capitalistic world and rely instead on the "eternal friendship of downtrodden peoples."

Let us illustrate. Why did the Soviets, who are more modest rice-eaters than we are and who had never been significant importers of the product, buy large quantities of surplus Burmese rice? They did so as part of a wider strategy—to implement their political program in Asia. To see this, let us first sketch the background of the Burmese rice situation.

The country's difficulties in this product were due, (1) to the expansion of world rice output generally and more particularly in countries such as India which were formerly heavy importers; (2) to Burma's faulty rice price policy which overpriced the commodity and harmed export business; (3) to China's emergence as an exporter to Japan and Ceylon; and (4) to the partial substitution of wheat for rice in places like Japan and India. At the time, the



United States had also made small sales of its own surplus rice in Asia.

The Russians, using their top leaders on tour, addressed large Burmese crowds without regard for the facts. Burma's economic difficulties were due solely to the Americans, who were using their surpluses to wreck Burma's rice market. The general public, ignorant of technical details, "fell for" this line. These people were delighted when Moscow announced a large purchase of their surplus rice, even if Russia did not need the product.

What was gained by the Soviets? They won the support of many Burmese and thus assisted the Soviet propaganda and subversion effort in that country. They acquired stocks of rice, which they might use to keep rice-eating satellites in line. They also tied Burma more closely to Moscow economically. This was done by a currency device—payment in overvalued rubles—which requires the Burmese to use the proceeds entirely in making purchases from the Soviet block. (Russia normally pays in transferable sterling.) But rubles may be quite inconvenient: available Soviet goods may be unsuitable, poor in quality, and over-priced by world standards. In any event, when the time comes for Burma to try to spend the rubles the Soviets will be in a strong position to dictate the terms, politically and economically.

This is just one case in a long line of more or less similar maneuvers that totalitarian state traders are capable of carrying out. They promise orders to countries having temporary difficulties in selling some primary products. But the selling countries want more than an occasional order; they want steady business, and are unsatisfied with the erratic course of Soviet buying which reflects lumbering changes in economic or political policy, emergency needs when Soviet plans go wrong, or downright diplomatic ideological opportunism.

Much the same may be said of the attitude of nations that export manufactures. In the advanced countries sellers usually are uninterested in Soviet offers to buy little other than the latest products of western skill, which have ready markets throughout the free world. Moreover, it is not prudent to supply the Soviets with the

latest products of western research when Russia does not adhere to any international patent conventions; nor do private sellers think it is wise to push sales to the Soviets when they do not accept such western practices as contracts that provide for neutral arbitration when disputes are involved.

### WESTERN EUROPEAN STATE TRADING

Most of the free world's state trading occurs in the domain of farm products, and much of such trade is carried out by the countries of western Europe. A brief discussion of this matter is important, partly because of the additional light it throws on the role of agricultural protectionism in the contemporary world. As we shall see below, the state trading that occurs on this side of the Atlantic is also confined almost entirely to farm products.

First, a word about nonfarm products that are state traded in western Europe. We find that they are confined to only a few articles, and that government trade in them is generally rooted in the need to protect public order or the existence of a state monopoly. Thus, western Europe state trading in manufactures involves such items as arms and ammunition, matches, pure alcohol, salt, cigarette paper, and processed jute articles.

Among the European nations, only Belgium, the Netherlands, Portugal, and Turkey are free of state trading. In the rest of the countries state trading in farm products represents a part of the government's effort to protect domestic agriculture against foreign competition, whether such competition originates with other Europeans or producers in distant continents. The record shows that use is made of tariffs, QRs, and also of state trading to assist local farm interests, and especially to slow down a further decline in the economic position of farmers. We may add that state trading is not a recent phenomenon.

An OEEC study provides an idea of the concentration of state trading in the agricultural field. One of the OEEC's committees, investigating how to accelerate the liberalization of Europe's imports from the dollar area, has supplied some interesting statistics

a few of which are cited below. These data show (1) that about 11 per cent of Europe's total imports from the United States and Canada (which comprise a large part but not the whole of the dollar area) are subject to state trading, and (2) a breakdown of state trading as between three categories of imports: foods and feedstuffs, raw materials, and manufactured products. The concentration of state trading in foods and feedstuffs is shown in Table 21.1.

TABLE 21.1

WESTERN EUROPE'S IMPORTS FROM THE UNITED STATES AND CANADA  
SUBJECT TO STATE TRADING IN 1956  
(as a percentage of imports in 1953)

	<i>Foods and Feedstuffs</i>	<i>Raw Materials</i>	<i>Manufacture</i>
Austria	7	—	—
Denmark	—	—	1
France	79	9	15
Germany	72	2	—
Greece	49	13	—
Ireland	65	—	—
Iceland	16	6	—
Italy	67	—	—
Norway	74	3	—
Sweden	63	—	—
Switzerland	72	—	—

SOURCE: OEEC, *Liberalisation of Europe's Dollar Trade*, Paris, 1956, p. 77.

### AMERICAN STATE TRADING

We in the United States, the citadel of the free-enterprise world, are engaged in a lot more state trading than most people realize. Though recent, the American practice bids fair to be with us for some time, and to reflect increasing rather than declining political pressure from the farm sector.

The center of the system is the Commodity Credit Corporation (CCC), a unit of the Department of Agriculture. State trading plays a subsidiary role in farm policy: it is one of the principal means by which the government endeavors to get rid of the mountains of farm surpluses that accumulate under price-support operations. Thus, government farm export programs may be regarded

as part and parcel of official price-fixing in agriculture. In superficial contrast to European practice, American state trading plays no protective role as such. Our system serves in an indirect sense, however, to protect agriculture by unloading surpluses that might otherwise embarrass the lawmakers.

We may say a word about the mechanics of selling. The CCC itself does not handle the day-to-day details of actual selling for export. Rather, the CCC uses regular private export firms as agents to carry out and conduct particular transactions with foreign buyers within the framework of over-all programs that have been planned in Washington. The use of agents, let us add, does not alter the fact that the United States is engaged in state trading. This is true for two reasons. First, the products involved are owned by the government. Second, the goods are sold at the government's risk—usually at a loss, since the accounting cost is the sum of uneconomically high support prices and storage charges. At times, in fact, the export prices have been ridiculously low; thus, \$2.00 potatoes have been sold by the government for export at a mere cent a sack.

### ECONOMIC COEXISTENCE

We have seen that ordinary private trade exists side by side with government foreign trade monopoly in free world countries that practice state trading. Some interesting issues arise from the coexistence of official monopoly and competition in a nation's international trade. Can the monopoly buy more effectively? Or, what is the same thing, how does competitive private trade stack up against a foreign trade monopoly? Experience to date is still inconclusive, in part because most transactions by monopolies have been made under unstable conditions that prevailed for a number of years following the last war.

An official monopoly could have some distinct advantages under certain conditions. It could, for example, substitute centralized buying for competitive bidding among numerous private importers. In a period of shortages, such centralized buying could result in lower purchase prices. However, the outcome would depend upon the

combination of factors present in each case. Are the suppliers unorganized or are they merged into a unified selling organization? If they present a solid front of their own, the outcome is indeterminate—there will be something close to bilateral monopoly. Perhaps the importing monopoly is the world's main market for a given product and the suppliers who are organized in another country control only a part of the world supply. In such a case, the importing monopoly appears to be in a strong position. Its centralized buying will probably reduce the intensity of bidding, as compared with a situation in which importing is done by a multitude of private traders. Another consideration is the character of the products subject to trade monopoly. If industrial goods are sold by an export monopoly and the sales are for the purpose of buying agricultural goods, the industrial nation is likely to benefit in most cases because, typically, industrial goods are subject to greater price manipulation and narrower price fluctuations than nonindustrial goods.

British bulk purchase arrangements are an interesting case in point. For a time after World War II, the British government was the sole buyer at fixed prices of the exportable surpluses of various New Zealand and Australian farm products. The arrangements called for annual price adjustments according to a price formula. If British export prices rose relative to Australian export prices, Britain made an annual lump sum payment to New Zealand and Australia that in effect raised the fixed price so that after the adjustment the terms of trade between Britain and the two supplying countries were kept stable. In the contrary case, namely a relative reduction of British export prices, the adjustment is exactly the reverse.

The value of such a scheme to either party depended (1) on the character of the initial terms of trade—the terms at the time when bulk purchases began on the above basis; and (2) movements in world prices—prices prevailing outside the agreement countries. If the original terms of trade were favorable to industrial goods, the scheme would tend to perpetuate such a condition. The major trouble would appear to arise, however, from discrepancies in prices between the agreement countries and outside countries. Assurances of a steady market for the exports of one of the agreeing parties

would tend to limit downward price fluctuations at a time when world prices of the goods in question were declining. The maintenance of parity pricing in such a case would place the import-monopoly country in a difficult position. It would have what was in effect a long-term contract to buy at higher than world prices; and its rivals in export trade would have an advantage because of lower costs resulting from lower-priced imports obtained in world markets. As a matter of fact, Britain sustained losses of this very nature for several years after the last war.

The tendency for an official import or export monopoly to do business on fixed contract terms, that is, on contracts usually running for a year or more, tends to exaggerate losses (losses on long-term commitments made before a price drop). A few officials, perhaps men with limited trading experience, will be making price commitments and deciding on the quantitative and timing aspects of purchases; they are unlikely to be as astute in their decisions as many private traders would be when operating in the same market. The errors of individual private traders would tend to cancel out, whereas those of the government officials would cancel out to a lesser degree or not at all. This explains the fact that government losses, when they occur, are likely to be quite large.

Of minor importance in the general field of state trading are foreign purchases by governments for departmental needs. This type of state trading is designed to meet the commodity requirements of government departments and not the country's import requirements of specific commodities.

The main feature of such arrangements is that governments generally do not buy in the cheapest market. They do not follow the ordinary commercial rule as regards prices. Instead, they deliberately favor domestic industries by (1) making themselves subject to the payment of ordinary tariff duties (such payments are merely bookkeeping adjustments and do not increase the effective costs of imports to the government), and (2) including duties and, in addition, price preferences. With respect to (2), for example, our own government accords to domestic supplies a price preference over and above the foreign cost plus the tariff duty. It is interesting

to note that the enlargement of the sphere of government activity in international trade tends automatically to increase trade barriers.

### INTERNATIONAL AGREEMENTS RESPECTING STATE TRADING

What measures have been taken to protect a country whose traders operate competitively, apart from cartels, in international trade? In the United States, we have relied mainly upon supposed safeguarding provisions in our reciprocal trade agreements and provisions of the GATT. Since 1934, for example, the following provision has appeared in reciprocal trade agreements: "In case of a government monopoly for import . . . the government agrees . . . that in making its foreign purchases of any product such monopoly or agency will be influenced solely by those considerations, such as price, quality, marketability, and terms of sale, which would ordinarily be taken into account by a private commercial enterprise interested solely in purchasing such product on the most favorable terms." The relevant provision of the GATT is similar to this, as will be recalled. It will thus be seen that this provision of trade agreements entered into by the United States, "the purchase on the most favorable terms," is exactly the same in principle as the Soviet declaration of "buying in the market which happened to be the most advantageous in each particular case." Strictly construed, a pledge of this sort granted by a state-trading country would not deny to its state trade monopoly the right to exercise its monopoly power in a discriminating-monopoly manner, provided that the power was used only to maximize economic gain. Unless an arbitrary formula is to be applied to cases of state trade monopoly, there does not appear to be much that can be done to restrain the use of that power for economic advantage. The basic difficulty is that not the use but the mere existence of monopoly power—whether in domestic or international trade—generally suffices to yield some monopoly gain.

For example, suppose the state trade monopoly agreed, for the sake of international comity, to buy at uniform prices regardless of the elasticity of supply in different markets. By such action the state trade monopoly would prevent itself from practicing discriminating

monopsony. Unlike the private competitive purchaser, however, the state trade monopoly could not prevent the size of its purchases from influencing the price it had to pay. The private competitive purchaser would carry his purchases to the point at which his marginal demand corresponded to market price, or to the *average* expenditure curve. A nondiscriminating monopsonist, on the other hand, would carry its purchases to the point where its marginal demand for the product corresponded to the *marginal* expenditure curve. Other things being equal, the monopsony case represents a smaller volume of purchases than the competitive one.

Another case which should be discussed concerns the power of a foreign trade monopoly to threaten to divert purchases from one country to another. The mere threat to do this will force the other country to weigh the cost of adjusting its economy against the loss resulting from the involuntary granting of a reduced schedule of prices. The monopoly country can easily improve its terms of trade by this process. But it should be recognized that a country does not need a monopoly of foreign trade in order to accomplish substantially the same result. Thus, in order to achieve the same purpose, some western European countries have employed the threat of reducing the import quotas assigned to particular exporting countries. And during World War II, the United States threatened (and rightly so) to reimpose coffee rationing in an endeavor to prevent the supplying countries from withholding supplies for speculative increases in price.

### PROBLEMS

1. "To admit that anything good may result from free private trade is to be guilty of servile grovelling before rotten capitalist ideas." *Evaluate.*
2. "State trading methods may easily be used to cover up some of the internal economic weaknesses of the outwardly monolithic Sino-Soviet system." *Explain.*
3. "Low Russian real wages despite moderately good productivity is likely to give the Soviets a competitive power in foreign trade that will intensify the leverage that results from the country's state trading system." *Evaluate.*



4. "If trade could be imagined as flowing freely between the Soviets and western Europe or the United States the official exchange rate for the ruble would be found to overvalue the Russian currency by about 100 per cent." *Explain.*

5. "State trading may offset the disadvantage which Russia has by virtue of requiring more transport per unit of production than any other major country." *Evaluate.*

6. "The general Western interest in world affairs lies in a stable and ordered progress, but this is an interest that is hard to maintain and easy to disrupt; Soviet state trading offers considerable opportunities of disruption by peaceful means." *Explain.*

7. "Excesses of the Soviet type of state trading cannot confidently be checked by a pledge of nondiscrimination." *Explain.*

8. "Soviet state trading lends itself admirably to the use of discriminating monopoly power on the buying side (monopsony); American state trading, in contrast, is incapable of being used in even a remotely similar way." *Explain.*

9. "Small free world countries are vulnerable to penetration by Soviet state trading whenever it operates on a sustained loss basis whereas the same may not be said about the use of such tactics against the United States." *Explain.*

10. "Western European state trading is in large measure an adjunct to other machinery for protecting high-cost domestic agriculture." *Explain.*

11. "CCC operations may not properly be classified under the heading of state trading in view of the fact that private exporters handle the transactions involved." *Evaluate.*

12. "It is the obligation of those who watch over the network of world trade to be constantly aware of the dangers that lie quietly in the barns and warehouses of the 'surplus' countries of the free world." *Explain.*

13. "A free world country which uses an official entity in peacetime as an import monopoly in the hope of improving the country's terms of trade is likely to learn that the arrangement serves only to make for periodic losses of great magnitude." *Explain.*

14. "State trading is also illustrated by the fact that the gentleman in the tall star-spangled hat is providing 75 per cent of the wages paid to American seamen." *Evaluate.*

15. "As we see it in Moscow, America can hardly complain of our practice of state trade when it costs the United States Post Office 11½

cents to handle one pound of magazine and newspaper mail for which the publishers pay only  $2\frac{1}{4}$  cents." *Evaluate.*

## **International Commodity Agreements**

Should some primary commodities be priced under international agreements rather than in the market place? According to the advocates of international commodity agreements, which includes the United States when some of our own export products are concerned, the answer is in the affirmative. They believe that free competitive world trade in some primary products does not provide the price stability that both producers and consumers really want. Some primary commodities, they feel, should be treated as a special case. Hence, the world needs intergovernmental commodity agreements that will govern production and trade—mainly the latter—in such products as wheat, sugar, tin, coffee, and the like.

The present chapter will attempt to provide an analysis of international commodity agreements in terms of the best known case—the International Wheat Agreement. The United States is a member of this arrangement, but Britain dropped out after becoming dissatisfied with the results. An analysis of the wheat agreement should give a good idea of the nature of international commodity agreements, the difficulties to which they give rise, and the alternatives to such agreements.

### THE INTERNATIONAL WHEAT AGREEMENT

After 17 years of effort and a full seven international conferences, an International Wheat Agreement came into being in 1949. The signatory nations pledged themselves to "assure supplies of wheat to importing countries and markets for wheat to exporting countries at equitable and stable prices." Practically all of the importing countries of the world and all the exporting countries except Argentina and the U.S.S.R. signed the agreement. It ran for four crop-years beginning with 1949-50.

The main features of the agreement were:

1. Designated exporting countries agreed to ship "guaranteed quantities" of wheat each year at prices no higher than a stated maximum. In the first year of the first agreement the quantity was 438 million bushels, the main exporters in the order of their importance having been Canada, the United States, and Australia.

2. Designated importing countries agreed to buy specified quantities from the exporting countries at no less than a stated minimum price. That is, the buying obligations of importers were effective only at the minimum price. In the first agreement, for example, Britain agreed to take nearly half of the total. The signatory nations did business through private trade channels or otherwise.

3. The agreement set forth maximum and minimum prices. These were \$1.80 and \$1.50 per bushel respectively during the first year, but lower minima prevailed in the other three years (as we show below). As long as the member sold the guaranteed quantity at the maximum price to importing member countries, it was free to sell any other wheat at any other price.

4. Transactions between importing and exporting countries were by negotiation. The countries were free to agree upon prices, provided that these were within the stated limits.

5. A Council was established to administer the agreement and to settle disputes. Voting on the Council was divided equally between exporting and importing countries, with each country's votes being in proportion to the size of its sales or purchases under the IWA.

In addition, the agreement provided that members could price wheat domestically as they pleased, except that it was agreed that each would "endeavor" not to operate domestic pricing "in such a way as to impede the free movement of prices between the maximum price and the minimum price . . ." for international wheat transactions.

The primary motive for reaching agreement on wheat, in the initial agreement as well as in those signed since, has been the fear of excessive surpluses. When such surpluses appeared before the last war, producers faced periods in which their production efforts were extremely unremunerative. Surpluses again plague producing countries, who believe in consequence that an international agreement will help to hold prices at levels that will not be contrary to the interests of consuming countries. Incidentally, because of high domestic wheat prices under our price-support system, most wheat agreement sales have necessitated a subsidy averaging about a third of the net export price.

The terms of the IWA have remained substantially unchanged in the second and third agreements. But there have been modifications in the levels of agreed prices, as one would expect in view of the changing position of wheat in the international economy. Table 22.1 shows the level of agreement prices and some of the results to date.

After the first agreement some significant changes occurred as regards membership. The most important development was the British decision not to participate in the second and third agreements. In the third agreement, however, Argentina among the big producers was added to the list of exporting countries.

#### **WORKING OF THE AGREEMENT**

It is commonly held that certain results would be obtained if nations agreed to stabilize the prices of a primary product and had assurances of sizable sales at such prices. A major expected result is that such an agreement would also stabilize prices outside the agreement and thus contribute to greater stability of (1) producers'

TABLE 22.1

WHEAT AGREEMENT PRICES, GUARANTEED QUANTITIES, AND RECORDED  
TRANSACTIONS UNDER THE AGREEMENT

Crop Year (August-July)	Agreement Prices (U. S. \$ per bushel)		Guaranteed Quantities		Recorded Transactions	
	Maximum	Minimum	Million Bushels	Percentage of World Trade	Million Bushels	Percentage of World Trade
1949/50	1.80	1.50	438	57	432	56
1950/51	1.80	1.40	538	58	531	57
1951/52	1.80	1.30	581	60	572	59
1952/53	1.80	1.20	581	63	572	62
1953/54	2.05	1.55	389	50	225	29
1954/55	2.05	1.55	389	43	290	32
1955/56	2.05	1.55	—	—	—	—
1956/57	2.00	1.50	—	—	—	—

SOURCE: International Wheat Council, *Annual Reports*, and the *New York Times*.

incomes and (2) international balances of payments. Minor expectations were that such an agreement would lessen the drive for bilateral wheat agreements, discourage high-cost production, and (especially as Canada and Australia saw it) define and limit America's export-subsidization of wheat.

This case, as is true of all others, must be seen in perspective. Thus, the first few years following the last war was a period of critical food shortages. Strong national price, marketing, and export controls existed in most countries. Only the United States among major wheat exporting countries allowed domestic producers to receive high international prices associated with the world shortage. Not unexpectedly, America was the only country to expand output well above the prewar average. Others sought to achieve "stabilized" prices for domestic consumers but really reaped only limited production (Canada, however, was affected more by the terms of the four-year Anglo-Canadian wheat deal).

On the eve of the first agreement United States and world prices were above \$2.20 a bushel, well below the postwar peak. Yet the *maximum* price in the IWA was set at \$1.80, while the mini-

imum was put at \$1.50 (less in subsequent years). Consuming countries could be expected to cheer for the IWA, but why did the exporting countries sign a four-year agreement on such terms? The answer is that the exporters feared an early contraction of import markets (as many countries recovered from the war), increased export competition, and the resulting strains on their own wheat price and marketing systems. Supplies expanded and the price fell to the agreement maximum in less than a year.

But the Korean conflict changed things. Active buying drove the "free" wheat price well above the agreement maximum. At this time the existence of the IWA had two effects: it served to encourage demand, as agreement wheat became cheap both in relation to non-agreement wheat and competitive agricultural products which compete with wheat for land use. It also served to discourage maximum production. Thus, there were insufficient incentives (except in the United States) to expand output in another period of shortage. "Stabilized" IWA prices acted perversely.

The final year of the first agreement was one of excellent weather. This, coupled with relaxed price controls in many countries, led to a bumper world crop. But new and higher support prices in the United States and Canadian export price fixing during the period of renegotiation of the IWA artificially held the "free" export price some 22 per cent above the IWA maximum. It was in this environment that the second IWA was reached, which fixed the agreed price range at \$2.05-\$1.55. Every indication pointed to increased supplies over and above the then-existing easy supply situation. As a result, Britain refused to sign the new IWA.

Before long both Canada and the United States began to sell wheat to non-IWA buyers at IWA prices. At the same time the United States, under Section 550 of the new Mutual Security Act, promised wheat against payment in inconvertible currencies rather than dollars. By now the world had witnessed two successive years of fine weather and bumper crops. But informal price fixing outside the terms of the IWA by Canada and the United States prevented the price from moving freely within the range of the IWA maxi-

mum and minimum prices. The United States also began to sell some wheat for local currency under Public Law 480. Considerable quantities were sold, in fact, at net prices below the IWA minimum, quality discounts considered. Surprisingly, however, the United States did not request IWA importers to take up their guaranteed quantities at the IWA minimum price. This action was based on a desire to keep in line with Canadian price policy. Thus, it was Canada's policy and not the IWA which was the dominant factor in pricing wheat. Some big members substituted their decision for the terms of the IWA, in defiance of the agreement's provisions that national export prices were to move freely between the maximum and minimum IWA levels.

#### **WEAKNESSES IN THE AGREEMENT**

The record shows that the IWA failed to fulfill the declared major objectives. Why was this the case? We shall see that the failure was due in part—in large part—to the nature of the agreement itself; and that it was also due in a measure to the special characteristics of the world wheat market during the period of the agreement.

First, we shall indicate the weaknesses of the initial agreement. This was the four-year period in which demand exceeded supply, and the IWA rigidly *fixed* rather than "stabilized" the price for three-fifths of the world's wheat trade at prices a good deal lower than those that would have been set on the average in the absence of an agreement. That is, the IWA's maximum price was to all intents and purposes a fixed price—one that persistently benefited IWA importers and penalized IWA exporters. At the same time IWA prices worked to raise prices for "free" wheat, that sold outside the agreement, thus bestowing a windfall on non-IWA exporters.

If there is a clear-cut conclusion that emerges from the record it is that the job of fixing a four-year price range for international trade in wheat is something that mere mortals are likely to do with



success in only a tiny proportion of the cases. No amount of expertise will guarantee that we can foresee the peculiarities of crop weather and general international developments.

The initial agreement contained another grave defect. It gave rise to serious price distortions and improper price relationships. Specifically, the IWA underpriced wheat in relation to other grains and in relation to livestock. It gave rise to some wasteful consumption of wheat, undesirable marginal acreage shifts, and an extension of government controls over grain production and marketing.

A third defect in the first agreement has to do with the quantity "guarantees" spelled out in the IWA. Importing nations were supposed to be able to buy guaranteed quantities at the maximum price and exporters were "assured" of markets for guaranteed quantities at the minimum price. The facts are that while IWA wheat was at the maximum price importers often found it impossible to buy at that price enough good milling wheat within the limits of their guaranteed quantities. The deficiencies would have been truly great had not fortuitous circumstances in the shape of fine crop weather in Canada and Australia come to the rescue. Guarantees to importers, therefore, cannot be counted on unless each major exporter holds large and expensive wheat reserves.

In the fourth place, guarantees to exporters did not fare much better. The fact is that the IWA thus far has failed to be tested in this regard. We discuss the details below in connection with our analysis of the second agreement, where the issues are brought out more sharply.

Fifthly, what about the IWA's stated purpose of reducing bilateral trade in wheat? The record here too records a mixed picture. Thus, transactions under the special bilateral Anglo-Canadian Wheat Agreement were allowed to be included within the IWA's first-year guarantees. But most of the bilateralism involving members occurred after the first IWA. As far as nonmember countries were concerned, however, the initial agreement must be recorded as having had no ameliorative impact: Argentina and members of the Soviet bloc, confirmed bilateral traders, continued along their accustomed ways.

Finally, the first agreement did not measurably relax national price and trade controls and what relaxation there was would have occurred even if there had been no IWA. Most exporting countries fixed producer prices well above the IWA maximum. Trade and marketing controls also remained in many instances in the case of both exporting and importing countries.

What difference did the second IWA make? First, it showed that the major exporters did not wish to test the IWA's provisions respecting market guarantees for exporting countries. The two largest exporters, Canada and the United States, are financially strong countries (and the main units of the dollar area) while most IWA importers are economically weak. For undisclosed reasons, the weak were not asked to take up their guaranteed quantities in the second agreement. In any event, the experience shows that the importing nations enjoy broader channels of escape and greater assurance of contract-enforcement than the exporting countries.

The second agreement also revealed weaknesses in the area of bilateralism, especially on the part of the United States, the professed champion of multilateralism. Agricultural surplus disposal legislation involves back-door bilateralism—sales under special two-country arrangements against (1) inconvertible currencies and (2) bartered materials. Some observers have even claimed that such transactions make nonsense of the IWA, particularly when the United States no longer insists that importers take up their contract quotas.

Finally, the second agreement shows that the IWA cannot be counted on materially to lessen the use of national price and trade controls in wheat. Both importing and exporting countries have been strongly disposed to raise prices to producers above the IWA maximum. These prices have been "defended" by rigorous import controls, high government stockholding, and elaborate subsidization schemes. Because of such controls and activities, (1) IWA export prices were prevented from moving freely between the agreement maximum and minimum levels and (2) movements in non-IWA prices were not allowed to reflect the changing supply-demand situation in the world's wheat trade.

Mention may also be made of one more matter. By now, only about a third of the world's wheat trade was covered by the IWA. A non-economic parallel would be the tail trying to wag the dog.

In the light of the record, why did the countries sign a third agreement? There appear to be several reasons. First, the United States wanted an agreement as an aid to the disposal of some of its huge surpluses, and for other reasons. Canada, which had been reluctant to join without the British in the IWA, finally decided to go along. Second, it was thought that output restrictions in producing countries coupled with bad weather might result in a situation in the future when something like the IWA would be useful. Third, a number of countries felt that renewal of the agreement was desirable to preserve the machinery for international collaboration and the examination of members' policies.

#### **BRITAIN'S REJECTION**

Further light on the IWA and its problems is to be had from yet another angle. We refer to the grounds on which Britain stated her refusal to go along after the termination of the first agreement. In Britain's view the wheat agreement failed in four major respects to make a positive contribution to the solution of the world's surplus wheat problem. These were:

1. That existing arrangements contain nothing to link the disposal of surpluses to the working of the agreement;
2. That the IWA does nothing to discourage continued overproduction;
3. That the agreement does nothing to increase consumption of wheat; and
4. That the agreement has no provisions to insure that prices would move freely even within the range permitted by the agreement.

These are weighty considerations, important to those concerned with the IWA as well as to students of international commodity agreements in general. We shall not elaborate on the British statement in view of what has already been discussed above.

**APPROPRIATE OBJECTIVES**

Failure of the IWA has been due partly to the seeking of questionable objectives, partly to the nature of the world wheat economy, and partly to the specific provisions contained in the agreement.

It has been incorrectly held that wheat markets have been excessively unstable, mainly in the sense of the relation between the highest and lowest *daily* price recorded each year during the depressed and confused decade of the 1930's. There was only the barest minimum of international economic order in that period—wheat fluctuations were exaggerated by many currency depreciations, a tangled web of new import barriers, and a maze of direct price controls in wheat markets. Moreover, daily price fluctuations tell only a small part of the story, since but a few sales are made on any one day and only a fraction of the year's total even in any one month. It is variations in *annual* average prices that are really relevant.

What does the record show with respect to such annual variations? Representative annual world wheat prices, as indicated by crop-year average British import prices from 1870 to 1939 are instructive. Let us take as our benchmark the maximum-minimum price range of the second IWA, 25 per cent, and see how many such year-to-year changes occurred in the past. A change of the indicated magnitude *never* occurred during the period 1870-1914, and there was only one that large in the 1922-30 period. But there were several such changes during the war and postwar period 1914-22 and again in the depressed 1930's. Thus, by the IWA's own criteria, British wheat prices were relatively stable during the period 1870-1939 except during war and economic depression.

The magnitude of the price changes that occur freely in markets tells only a part of the story. We must also ask whether such changes were economically beneficial or harmful. Often, price changes in response to extreme developments in any crop year may be beneficial in the economic sense. Crop disasters occur, and when they do the appropriate price relationships are those which encour-

age expanded wheat sowings and restrict use for inferior purposes, such as animal feeding. Price changes produced in the market place must be contrasted with those usually resulting from government intervention and its political pricing, since the latter generally tend eventually to increase rather than check price instability.

*The Surplus Problem.* Most of the existing difficulties in world wheat are related to the huge surpluses in Canada and the United States—stocks that might take 20 years to liquidate if these two countries' use, exports, and crop yields remained at recent levels.

It is this problem—the proper disposal of surpluses—which many hold to be an appropriate objective for an international wheat agreement. Perhaps it may not be too much to expect such an agreement to deal, gradually to be sure, with national wheat policies and programs so as to effect those modifications which are required in order to have a freer, integrated world price structure in wheat, contraction of output in high-cost areas, the maintenance or expansion of production from low-cost sources, and freer international trade in the product. Clearly, an international agreement which would accomplish such aims would be quite a different kettle of fish than that which we have described in this chapter.

*The Moral of Wheat.* Experience in wheat does not necessarily condemn all international commodity agreements out of hand, because there are important differences among primary commodities. Thus some are mineral products, production characteristics of which are similar in many cases to those in manufacturing industry, while others are the product of perennial plants and not annuals such as wheat. The case of wheat nevertheless indicates the great difficulties that are likely to be encountered in commodity agreements. "Equitable and stable prices" are indeed worthy desiderata, but the manner in which they are to be attained is all-important.

Technically, the price of a commodity is equitable and stable if, given the quantity demanded at that price, the necessary resources earn as much in producing such commodity as they could earn in alternative employments. That is, the price conforms to the opportunity cost of the resources used to produce the quantity wanted at that price.

It is often said that equitable and stable prices are not likely to be realized under free-market conditions because of the low elasticity of supply and demand. That is, a fall in price does not lead to a decrease in output nor to an increase in consumption such that the price declines only slightly; nor does a rise in price either evoke a substantial increase in output or choke off much of the demand. But does low elasticity unfailingly characterize primary commodities? Have we not been guilty of elasticity pessimism on the basis of excessive attention to the period of the depressed 1930's, when the decline in general demand kept resources in primary production? If total demand is kept at high levels, in the industrial countries by way of monetary and fiscal policies and in the poorer nations through development programs, there is every reason to believe that reasonably high price stability will be attained. For it is then that factor mobility is near the optimum level, and supply adjustments facilitated so as to keep availabilities fairly steadily attuned to changing market requirements the world over.

### PROBLEMS

1. "The assurance of a market for a maximum of wheat at a minimum price was never worth much to wheat exporting nations." *Evaluate.*

2. "Wheat exporting countries are interested in rationalizing wheat production, especially in the importing countries." *Explain.*

3. "Britain should restrict her own high-cost wheat output if she is to criticize the faulty economics of the IWA." *Explain.*

4. "No commodity agreement can be better than the policies of member governments." *Explain.*

5. "The second wheat agreement showed that the policy of exporting governments rather than the IWA was the real bulwark against a collapse in wheat." *Explain.*

6. "An international wheat agreement which permitted a Wheat Council to examine and take action respecting domestic production policies is urgently needed." *Evaluate.*

7. "The successful advance negotiation of a three- or four-year price range for international wheat transactions is beyond the competence of man." *Evaluate.*

8. "Public Law 480 sales almost make a mockery of the IWA." *Explain.*

9. "The international grain trade and the wheat agreement are stuck in a rut, and fresh thinking is needed to get them out." *Explain.*

10. "Surfeit, behind a front of stability, now seems to be the norm in wheat." *Explain.*

11. "The IWA minimum price is not of much collective worth to exporters, as all the exporters are single sellers in effect if not in name and all have shown in the face of towering surpluses that they can and will prevent a collapse in price." *Explain.*

12. "The IWA provides the United States Administration with a plausible defense when Congress needles it to get rid of wheat at even lower prices than the IWA minimum." *Explain.*

13. "The United States has no direct need of the IWA, though indirectly the agreement does throw a cloak of respectability over the subsidy of wheat exports on a vast scale." *Explain.*

14. "There is a good reason for the IWA's state marketing system. Prices used to collapse because thousands of farmers rushed to sell before they weakened further; now a collapse could only result from a deliberate decision of one or several governments to sell regardless of the consequence." *Evaluate.*

15. "European governments, which in some cases support wheat at prices above the American support level, could contribute to stability in wheat by encouraging a shift from wheat to coarse grains for which there is a ready and expanding demand for animal feed." *Explain.*

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**PART VI**

**ECONOMIC DEVELOPMENT  
AND INVESTMENT**



## The General Problem of Economic Development

One of the most powerful forces in existence today is the desire for economic development among countries low on the scale of per capita production and consumption. There are hundreds of millions of individuals who live in many lands and who aspire in the short run not to another shirt, but to improvement in the form of a shift from a garment with ten patches to one with, say, only two patches. (Of course, they would prefer a new shirt.) And there are hundreds of millions who prepare their land by scratching it with a stick, after which they sow seed of poor quality; such people aspire in the short run to a state of things in which they will be able to plow deeply, use selected seed and perhaps some fertilizer, so that they may realize much better yields and thus improve their consumption. Several hundreds of millions also must put up with roads or trails that are literally impassable during the lengthy rainy season; they aspire to improvement in the form of at least a few facilities roughly of the kind we call farm-to-market roads. These hundreds of millions may never have used electricity in any form, though they may have heard that streets are lighted and some factories powered electrically in the province's main town and in the capital city. A long list of examples of this type could be cited.

### AN ATTEMPT AT DEFINITION

The people just referred to live in so-called underdeveloped areas. There are not just a few such people in the countries which are said to be undeveloped. If there were, the countries would be wrongly classified. Broadly speaking, economically underdeveloped countries are those in which per capita production is low but in which there is a substantial *potential* for improvement through the application of *known techniques* of production and administration. Like the giraffe, an underdeveloped country is hard to define with precision but not difficult to identify.

There are of course degrees of economic development—homogeneity is most assuredly not a characteristic of the world's underdeveloped areas. This is true of political features as well as those that are economic in nature. For instance, some are old independent countries, others only recently established as sovereign states, and still others are colonial or semi-colonial areas. With respect to development aspects, countries may be ranked along a scale, and it is also possible to rank regions within countries. Ethiopia and India, for example, rank low in development among the countries of the world. Southern Italy ranks low regionally within that country, as does the northeastern part of Brazil within that nation, and the Andean sector within Peru. Areas may also be ranked by continents; such rankings may serve a useful purpose mainly by providing a broad perspective on the "problem of underdeveloped countries." Specifically, most of Asia and Africa comprise areas that present the greatest problems inasmuch as they are the most backward economically. The Latin American area, or much of it, occupies an intermediate position.

The United States is at the other extreme. It is still growing and in fact must continue to do so if economic welfare objectives are to be more or less continuously attained. But we are not an underdeveloped nation. We do not have any appreciable capacity for improving our per capita output simply by making more widespread use of known techniques of production. Rather, we are im-

proving our productivity by tapping science (including science in management), innovating on a grand scale, augmenting the supply of capital, and working in effective teamwork within a marvelous structure of incentives that includes production-stimulating relations between government and business.

What may be said in quantitative terms about the relative degrees of development in various parts of the world? Let's turn to some statistics. The available data do not cover as many categories of information as we would like, nor are the categories strictly comparable in all cases. In particular, the data are deficient in the sense that a given concept may mean one thing in Country X and another in Country Y.

TABLE 23.1

SOME INDICATORS OF RELATIVE DEGREES OF DEVELOPMENT,  
SELECTED COUNTRIES, EARLY 1950's

Country	Annual Growth of the Popu- lation	Rural Popu- lation as a Per- centage of Total	Acres of Agri- cultural Land per Capita	National Income per Capita (dollars)	Daily Calories per Capita	Inhabi- tants per Physi- cian	Road Miles per 1000 Square Miles	Electric Power Produced per Capita (KWH per year)
United States	1.7 <sup>c</sup>	36 <sup>c</sup>	6.8	1847	3120	770	1123	3350
Brazil	2.4	64	2.0	190	2350	3000	103	236
Chile	2.4	40	8.0	265	2340	1800	116	643
Egypt	2.4	70	0.3	106	2450	3600	—	30
India	1.4	83	1.0	59	1970	5700	—	18
Peru	2.9	65	5.0	117	2077	4500	44	141
Venezuela	3.0	46	7.2	518	2280	1900	30	193

SOURCE: United Nations, *Statistical Yearbook*, and National Planning Association, *Technical Cooperation in Latin America*, Washington, D. C., 1956.

Table 23.1 shows some indicators of stages of growth with respect to selected countries in Africa, Asia, and Latin America. Note that India's annual population growth is the lowest on this list. Because the country is already densely populated, however, a 1.4 per cent annual growth rate is high for such a country. Venezuela, in contrast, has no trouble in expanding at a rate of 3 per

cent in view of its relatively abundant resources and sparse population; in fact the country helps to finance a large flow of migrants from Europe. The concept of "rural population" must be handled with care when international comparisons are involved. This is because some countries count as "rural" communities that have populations just under 10,000 (in contrast to the United States limit of 2,500). Clearly, India has a very large rural population. What is "agricultural land"? This too is variously defined in different countries. The figures nevertheless are of some interest. Note the small amount of land per capita in heavily populated Egypt and India as compared with the countries of Latin America and the United States. The rest of the table shows comparative data in terms of income per capita, daily calorie intake, inhabitants per physician, road mileage, and electric power production per capita. The last-mentioned is of special significance for development, since it is a good indicator of the amounts of inanimate energy with which workers are aided in production. The low level of electric output in India and Egypt points up the marked economic backwardness not only of these two countries but also of most nations in Africa and Asia.

We may also show quantitative international comparisons on an analytically more significant basis. The relevant data, however, exist only for Latin America among the underdeveloped parts of the world. The particulars are indicated in Table 23.2, where comparisons are made with the United States. Profound differences in economic structure are mirrored in the employment figures. Such differences are also reflected in the data on income.

With respect to structure, note especially the respective proportions of the labor force engaged in agriculture. Three-fifths of the Latin Americans, but only a tenth of the Americans, work on the land. Industry accounts for a sixth of total employment in Latin America, in contrast to a third in our case; and the service sectors of commerce, government, medical professions, and so on employ a fifth of Latin American labor whereas one-half of the American labor force falls in this category.

On the income side, Latin American agricultural workers have

TABLE 23.2  
LABOR FORCE AND GROSS INCOMES BY SECTORS,  
LATIN AMERICA AND UNITED STATES, 1953

Sector	Labor Force				Gross Income per Member of Labor Force (in dollars*)	
	Latin America		United States		Latin America	United States
	Millions	Per- centage of Total	Millions	Per- centage of Total		
Agriculture	33.9	58.1%	5.8	9.0%	\$ 303	\$3,090
Industry and construc- tion	9.6	16.5	21.0	32.6	1,108	5,726
Mining	0.6	1.0	.9	1.6	2,800	6,637
Transportation and pub- lic utilities	1.9	3.3	4.4	6.7	1,528	6,426
Commerce, government, and others	12.3	21.1	32.4	50.2	1,307	4,709
Total or average	58.3	100.0	64.5	100.0	\$ 713	\$5,037

\* Adjusted in terms of 1950 prices.

SOURCE: United Nations, *Economic Survey of Latin America, 1953*, New York, 1954; and *National Income, A Supplement to the Survey of Current Business, 1954*, Washington, 1955.

a per capita gross product that is only about a tenth as great as that of their American counterpart, while workers in industry produce only a fifth as much. Latin American miners perform relatively best, as one would expect on the grounds of comparative advantage. Thus, gross product per Latin American miner is nearly half as great as that in American mining. Over-all, the Latin American gross product per member of the labor force is only about a seventh of the level recorded in the United States. Though comparable data are not available for Asia, it is doubtful whether the typical Asian worker's annual gross product amounts to half of that shown for Latin America.

Thus, the United States is high—if not the highest—on the scale of development. Great Britain, Germany, most of the other



countries of Western Europe, and Australia, Canada, and Japan shade off from the United States and are also generally regarded as developed countries. They too must depend mainly on science, innovation, and augmented capital, as well as upon social mobility and entrepreneurial energy, if per capita productivity is to continue to improve. But the role assigned to the application of known techniques of production and administration is larger in such countries than in the United States. It is larger if only because they have much to gain from borrowing and adapting techniques that have been developed and tested here in the United States. But we must beware of injecting chauvinism: transmission of techniques does not proceed along a one-way street. The United States borrows, or adapts, more foreign technical and production ideas than most citizens realize; some of such ideas even originate in countries that are decidedly underdeveloped economically. Incidentally, we should point out that the American Way of Life is not the goal that all peoples seek.

This and the succeeding chapters deal with countries that rank low in the scale of development, the main economic problems they encounter, and the domestic and international measures that seem appropriate for facing up to the challenges. The field of economic development, incidentally, was almost unoccupied territory until recent years, when economists began "to swarm into it like forty-niners into California." Despite the abundant literature, however, there is no universally accepted theory of economic development and growth, nor even agreement as to the variables on which attention should be focused. But this is not the first time that the tasks of economic statesmanship have been faced without benefit of theory that had high guidance value.

### **WHY ARE SOME COUNTRIES UNDERDEVELOPED?**

There is no simple or universally valid explanation why the poorer countries, which contain most of the world's people, are economically underdeveloped. It is not that some of them failed

to develop a culture and civilization of their own, for a majority of the world's most ancient civilizations are in today's economically underdeveloped areas. It is not that large blocks of people have no appetite for the good things of life, including the more or less complex gadgetry that makes up a part of contemporary Western civilization. Nor is it that natural resources have been lacking in all or most cases, for many of the underdeveloped countries have a fair assortment of such resources and a few are even richly endowed.

It has been wisely said that economic development is of the same stuff as the human beings who go to make it. If this may be used as a take-off, clues to our basic question are to be found in the people themselves, in the character of the regions in which the countries are located, in the nature of the leading institutions, in the ratio of population to resources, in the history of the relation between government and the people, in the social importance or status of non-economic occupations (such as the military) as compared with economic activities proper, in attitudes toward thrift and capital formation, and indeed in the capacity to save. This list is not exhaustive, of course. For instance, the literature of peoples, and their religion or religions may also be factors helping to shape economic development.

The development process is inherently complex. This is so whatever the political form of the society involved. But the complexity is mainly technological in a centrally-planned, ruthless police state, where people are ordered around and treated essentially as units of human machinery. In very marked contrast, free societies are characterized by innumerable, scattered seats of decision-making, in which self-interest is the main factor that guides individuals in the making of economic choices of all kinds. The individuals are free to exert themselves to the degree that they personally desire, in the directions that they personally choose, with advice and counsel usually available in many quarters but without fear of orders and brutal compulsion from agencies of the police state.

As far as economic growth is concerned, freedom makes for a

slower pace of visible and apparent progress than usually results when a similar complex of physical and human resources is compelled to respond to the lash of an all-powerful, authoritarian bureaucracy. Authoritarian rule can force people to pull in their belts on a colossal scale, for the sake of capital formation at forced draft. Consumption is involuntarily sacrificed to speed-up in heavy industry, as resources that a free people would use for the production of consumer goods are employed instead to produce plant and equipment as well as to maintain "support" for the regime.

Note that the slower pace of development under freedom is not necessarily objectionable in itself, or even a matter for criticism. The point is simply that mere speed is not a virtue that can be claimed by the champions of freedom. Nor is mere physical output, in which units of shabby goods count just as much in the measurement of "performance" as the production of items that meet true consumer specifications. Nor can people always accept at face value reports of aggregate performance as published by the authoritarian powers that be—the unannounced shift in reporting output, from the regular barn yield basis to a (higher but misleading) biological yield basis, to cover up shocking declines in Soviet farm output is a classic case in point.

#### **RESOURCES: A PRELIMINARY COMMENT**

Before we proceed, we must indicate something that may otherwise be overlooked in our detailed discussion of the main reasons why per capita output is low in many countries. Economic growth depends partly on available natural resources and partly on human behavior or the way in which people use resources. Our main interest will be in human behavior, because this is the area in which socioeconomic therapy is applicable. But we must recognize that in some cases the real limiting factor with respect to development is the poverty of natural resources. It is this poverty, too, that often explains a part of the observed differences in economic well-being between various countries.

### THE PEOPLE

It is of course an understatement to say that the behavior of man is a subject that is only imperfectly understood, especially in the context of economic development. We all know that the field of human behavior contrasts markedly with the natural sciences, which use material that lends itself to repeatable experimentation. In this book, of course, we can try to deal with only a small part of the subject of human behavior, and then only from a special angle. Our aim is to seek to get some insight into problems of economic growth and the vital role played by man's behavior in connection with development. That is, we are trying essentially to understand a big area of social change.

This field usually is the preserve of the sociologist. But the sociologist has not yet done very much that ties in specifically with the relation between human behavior and economic growth. Hence, we shall have to rely on observation and analysis from the vantage point of the economist.

Observation of growth situations reveals that development depends to a significant extent upon *attitudes* that people hold. There are a few key ones to which we must address ourselves. What are the people's attitudes with regard to work? Variations in such attitudes among different people have a bearing upon relative degrees of development that have been attained. What about attitudes toward thrift? And attitudes with respect to wealth, invention, and knowledge? If we knew all there was to know about these questions, we could almost confidently blueprint the course to rapid economic development for many countries. We could then specify much about such key factors in the process of economic change as the kind of men who make good innovators, the type who excel at mere imitation, and the men who resist change in the area of production as well as the reasons why they do so. The following comments sketch some of the highlights.

First, we take up the matter of attitudes toward work. There are national psychological differences with regard to the willingness to expend effort. Some people desire goods and services to an ex-

tent that they are prepared to make a big effort to obtain them; other people feel differently and do not wish to make much of an effort. The latter include those who live by an ascetic code—people who are found mainly in areas in which Hinduism and Buddhism predominate.

Attitudes toward manual labor are also pretty much in the picture. Concretely, the situation in which trained agricultural specialists in some countries desire to work only behind a desk in the capital city, rather than soil their hands in the countryside, is not conducive to a high rate of development in the important field of agriculture.

In some areas of the world people actually have a very restricted knowledge of the goods that are in existence and the use that may be made of them in consumption. Such people have a relatively poor attitude toward work because they do not see themselves confronted with sufficient material inducements to expend extra effort. For example, illiterate people will not extend themselves effortwise in order to be able to buy newspapers and books. Habit and taboo also restrict wants in some cases, with the result that extra income beyond the conventional level often does not seem very attractive to the people in question.

Attitudes toward thrift are partly traceable to some of the same factors as those just described. Thus, people who know little about the range of available goods and services are not likely to want to engage in effort that would permit them to expand purchases next year by practicing thrift today. The factor of legal rights is also relevant. Men who do not know what their legal rights are, or who lack knowledge of the means by which they are enforced, or who feel that enforcement is not impartial, engage in little thrift. Of course, it goes without saying that the very poorest people have no capacity to save.

The attitudes toward wealth are also of some significance. In particular, the behavior of the wealthy is important. What do they do with their wealth? And what are the sources of such wealth? Do they invest it in productive activities, or use it to finance high living? In this connection, inequality in the distribution of income

is less important than the use made of wealth. The classic case of luxurious living on the part of the typical Indian prince versus the investment of earnings by a Henry Ford well illustrates what is involved. And what is the status of men who hold wealth in different forms? In particular, how does the status of the man whose wealth is in the form of productive investments—acquired through his own effort—compare with the man whose wealth is inherited land? It is no accident that countries in which land-owners still comprise the aristocracy are relatively less developed.

Some peoples find themselves in the groove of routine, and so operate at low and stagnant levels of productivity. Others have incentives to invent, and especially to use labor-saving methods of production. Interest in classic scholarship has characterized a number of underdeveloped areas. But such countries have not had much interest in science, or they have not enjoyed much freedom to experiment. Hence, their rate of invention has been relatively low.

Attitudes toward trade and money-making might also be mentioned. Specifically, the low status of trade was one reason why Spain, in contrast to Britain, failed to make good on economic opportunities several centuries ago. The same factor partly explains why China developed so much more slowly in the past century than trade- and money-conscious Japan.

The foregoing discussion should indicate the role of attitudinal factors. However, it must not be assumed that attitudes are always the product of choice. Sometimes they are not. Thus, attitudes toward work may depend partly on physical conditions. Where there is malnutrition and debilitating disease men's capacity to do exhausting work is limited. In such cases, unfortunately, there is a vicious circle that takes the form of malnutrition, low productivity and hence low purchasing power, malnutrition, and so on.

#### **REGIONAL ASPECTS**

We now address ourselves to what may be called "some geographic aspects of underdeveloped areas." Where are most of such

demand and thus the desire to do more work. Trade also aids specialization by introducing new ideas with respect to techniques and social relationships. Moreover, trade aids specialization by releasing capital that would otherwise be tied up in inventories of goods kept by the family. When such inventories are kept centrally by merchants, the community needs fewer stocks in relation to annual consumption. The resulting addition to capital permits some specialization in production that would otherwise be foregone. Finally, as Adam Smith well stated, trade encourages specialization since the division of labor depends upon the extent of the market.

Institutions that encourage mobility of resources speed growth. People with ability must be relatively free to move from poor to good occupations, to move into better paying jobs within their general field of work, and to move out of a stagnant or slow-moving area of the country into one that is expanding. Few underdeveloped countries adequately meet the institutional requirements of mobility. In some there is strong social stratification, so that the upper classes are not regularly and sufficiently refreshed with promising newcomers from lower-income classes. In other countries, strangers to an area are unwelcome and discriminated against regardless of the contribution they can make. In still others, land ownership is concentrated in few hands and thus some superior producers are blocked in attempting to manage operations of a size larger than those in which they are already engaged.

#### **THE POPULATION QUESTION**

Countries anxious to develop face two major situations under the general heading of the population problem. First, for most of them population is expanding rapidly by historical standards even in the face of existing high densities of population. "Death control" is fast being extended to underdeveloped countries, through greater use of modern medical practices and improvements in public health, but there is no offsetting decline in the birth rate. It is hard to raise the level of living when population is increasing,

as it is, at not far from 1 to 3 per cent per year in many underdeveloped lands. Note, for example, what a 2 per cent yearly increase means: it represents a doubling of the population every 35 years. Thus, a steady increase in output at a rate higher than that of the rate of increase of a fast-growing population may be very difficult to achieve. One important fact may be cited in this connection. The United States—with all of the advantages of sparse population and good land, vast capital outlays on plant and education, and its development-oriented institutions—achieved no more than a 4 per cent annual increase in per capita output during the great expansive era from 1870 to 1930.

Secondly, policy-makers must have an adequate understanding in detail of the population aspects of their development problems. This is necessary in order that appropriate measures may be taken to meet situations on the population front at the same time that really big, continuous, and coordinated efforts are being made on the production front. Let us illustrate. Densely populated underdeveloped countries generally experience high mortality rates in the pre-productive age group. This means that resources are effectively wasted in rearing children who never reach the age in which they can begin to produce. For example, in India about a fifth of the national income is devoted to consumption by children who die before 15. A much smaller proportion of the national income is used to rear children who die before that age in a country such as Britain. If India were able to reduce mortality in the pre-productive ages, and if it were also able to cut the birth rate, there would be a substantial increase in real resources available for that nation's economic development.

It is because of situations of the type sketched above that many specialists are pessimistic about improving levels of living in underdeveloped areas where population continues to grow as fast as it has in recent decades. They argue that technological developments probably will take care of growing requirements for minerals and, with the advent of nuclear power, of energy. But they are of a different view with respect to food, at least for a number of important underdeveloped countries. Only time will tell what



the outcome will be, of course. If it does nothing else, however, the population problem demonstrates the urgent need to accelerate economic development.

Population pressure, let us hasten to add, is not all on the debit side of the ledger. One credit item must be referred to, lest we lose perspective. We refer to people as productive resources, and particularly to the large fraction of the labor force that is in agriculture. From half to two-thirds of the people live off the land, most of them eking out a mere subsistence. As agricultural techniques improve and more capital is invested in agriculture, and especially as employment opportunities outside agriculture increase, more and more people can be released from agriculture to meet labor requirements in industry. Moreover, not all underdeveloped countries are overpopulated. Some, in fact, can use a greater population to advantage, in the sense that the population is fairly low in relation to non-human resources. The countries of Latin America generally fall into this category. In such cases per capita output could be expanded if there is an increase in population, partly because of opportunities thus opened to new industries that await the growth of a larger domestic market in order to be assured of minimum economies of scale in production.

#### **GOVERNMENT AND THE PEOPLE**

The content of legislation and the art of public administration have much to do with the pace of economic development. In this connection one stark fact needs to be emphasized: most of the world's governments are now, and seemingly always have been, rather corrupt, more or less disorganized, and generally inefficient by standards that prevail in the most advanced countries. Developing a really good public administration is a very slow business, especially if only a handful of citizens are imbued with the urgency of accelerating economic development. There is an important corollary: economic growth would almost certainly be impossible if existing bureaucracies in typical underdeveloped areas were given the task of developing the national economy under systems of cen-

tral planning. Fortunately, it is unnecessary to operate on such a basis. What is needed is some combination of private and government action, in proportions that reflect the realities of the various country situations and especially the realities with respect to individual incentives to work, save, and invest.

The relation between government and the people varies from country to country and within a country from time to time. On the latter point, it is instructive and perhaps comforting to note that the British government at the beginning of the nineteenth century was rather corrupt; it is perhaps as close to a model government today as can be found anywhere in the world.

Corruption is one of the worst enemies of development in many lands. Petty bribes to officials are not the serious thing, since such "greasing of the palm" usually is a form of payment for services to underpaid officials. The thing that is particularly damaging to economic growth is the bribery that assumes large proportions and that cannot adequately be foreseen by the private producer, since it discourages investment and tends to make for a sense of futility in the big private sector of the economy.

The failure to maintain public order\* is another obstacle to growth in many places. Mobs get out of hand and pillage property. The police offer insufficient protection, and sometimes even appropriate property for themselves. Courts may be prohibitively costly and so prove to be ineffective in many cases. Private measures to protect property may thus be very expensive as compared with the pro-rata sharing by producers of the costs of an efficient public apparatus for maintaining order and general obedience of the law.

The identification of governments with a particular section of the public often leads to instability through the promotion of a limited interest at the expense of the general interest. Landlord governments may be pitted against tenants and farm workers, or vice versa. Or one government may favor industrialists, and another the workers. Shifting back and forth between such opposing governments does much to make for very unstable economic expectations. The main economic consequence is a strong impairment of incentives to invest.

Finally, economic development is slowed down if there is improper and wasteful use of resources by government. In general, governments think too much of investments in concrete projects and too little of programs to improve persons as producers. The photographable building usually means much more to the authorities than investment in public health programs, education, and an agricultural extension service. Moreover, they may spend too much on the military and too little on basic roads and irrigation projects.

#### **SAVING AND CAPITAL FORMATION**

Partly because of the factors outlined under the above six headings, and partly for a host of other reasons, saving in underdeveloped areas is much lower than that which is required for a healthy pace of development. To an important degree, a vicious circle is encountered: per capita production is low in relation to the elemental needs of the people, so that saving is low, with the consequence that the resources that are available to augment real capital are correspondingly low. This means that poor and infertile land continues to go without fertilizers or proper drainage facilities, and that mere brawn and manual skill remain substantially unaided by the "inanimate slaves" that we call machines and capital equipment.

It is not easy to raise the rate of saving in underdeveloped countries because of widespread poverty. But in the last analysis a high and sustained rate of domestic saving must be a major goal. When not much is done to stir the stale pond of underdevelopment, the average rate of domestic saving may amount to 5 to 6 per cent of domestic national product and the marginal rate of saving perhaps a tiny bit higher. A key objective of policy should be greatly to increase the marginal rate. That is, measures must be taken to expand the people's real income and simultaneously substantially to increase the fraction of any increased income that people devote to saving. For example, if the average rate of saving is 5 to 6 per cent of domestic gross product, and measures which break the developmental ice succeed in raising domestic product

by, say, 2 to 3 per cent a year, saving policy should give great emphasis to measures which increase the marginal rate to as much as 25 per cent or more. The stage would then be set for a much-desired *cumulative* expansion.

### SOME COMMON MISCONCEPTIONS

Because the economic problems of underdeveloped areas are serious, and in view of the fact that many influential people in underdeveloped countries look to the United States for assistance in one form or another, it is essential that Americans have a reasonably good understanding of the subject. Such an understanding requires some discussion of a few of the common misconceptions that keep cropping up in various places—in international agencies, at official international economic conferences (incidentally, the underdeveloped countries outnumber the developed nations), in some public meetings in the United States, in the writings of some foreign economists, in debates held in foreign parliaments, and so forth. An appraisal of these misconceptions is doubly important inasmuch as many writings are passed off as “objective analysis” when they are in fact little more than special pleading or sheer propaganda. Moreover, the United States, as the wealthiest country, is not infrequently the butt of much baseless—but emotion-stirring—comment.

### PLANNING AND THE MARKET ECONOMY

Some widely circulated reports of international agencies have made much of elaborate government “programming” schemes. Big consumption and investment targets have been based on statistical projections of demand and output, and various and sundry economic ratios. Such planning can be executed and the substantial targets reached, we are told, without much government ownership and control of the economic system. But no systematic case has been presented to show that this kind of planning can be implemented without far-reaching government controls over the private economy

or that existing governmental facilities are adequate to the task if the objective were a desirable one.

It is a misconception to hold that elaborate development planning can be superimposed on the private economy and ambitious production targets realized on a forced-draft basis without using controls that would seriously interfere with or undermine the mainstays of the economy—namely, the private producers in agriculture and industry. A country either operates under a market economy, or it does not; few are deceived by the device of merely paying lip service to the market mechanism.

Though the details will be spelled out in the next chapter, we must emphasize that there is much that government can and must do, consistent with the market economy, to accelerate economic development. The growth road does not run exclusively through private territory or exclusively through government terrain. It runs through both. The point is simply that action in the two sectors must be consistent. It may also be remarked in passing that foreign economic development need not and probably cannot be carried out in the American image.

#### DEVELOPMENT AND "NEEDS"

It is well known that the idea of needs is more appropriate to the field of charity than to economics. (The discipline could not otherwise have been known by the unduly harsh name of the "dismal science.") As a rule, those who plead in terms of needs do so only by indirection; at times, however, the arguments are exasperatingly explicit, especially when the target is Uncle Sam. For example, it has been said that foreigners' inability to obtain the dollars they want "means that the United States does not purchase merchandise and services or lend money in an amount sufficient to cover the needs, *justified or not*, of other countries."<sup>1</sup>

In view of what has already been indicated regarding the various degrees of domestic house cleaning that many countries will have

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<sup>1</sup> United Nations, *The Economic Development of Latin America and Its Principal Problems* (New York, 1950), p. 19; italics supplied.

to undergo if there is to be a solid basis for development, it is no exaggeration to say that such statements border on the irresponsible. Do they not render a disservice to those underdeveloped countries that are really doing all they can to justify liberal American long-term financing?

#### CHEATING VIA THE TERMS OF TRADE?

• Another misconception, or series of misconceptions, revolves around the subject of the terms of trade. Specifically, there is a doctrine that the terms of trade historically have moved against countries that produce raw materials and foodstuffs and that the fruits of technical progress accrue to the industrial countries.<sup>2</sup> All manner of price statistics are supposed to support this charge.

But this is a case in which the statistical record with respect to prices does not necessarily prove anything either way. The simple fact is that industrial products, historically speaking, have shown great improvement qualitatively in relation to raw materials. For example, automobile tires now hold up for as much as 30,000 miles versus 10,000 some years ago; but today's bushel of wheat does not yield a larger quantity of bread. If, then, allowance is made for qualitative improvement of traditional manufactures as well as wholly new products such as those in the field of chemistry, it is extremely doubtful whether the terms of trade really have been adverse to the countries that export primary products.<sup>3</sup> Yet

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<sup>2</sup> See, for example, the following United Nations publications: *Measures for the Economic Development of Underdeveloped Areas*, 1951; *Relative Prices of Exports and Imports of Underdeveloped Countries*, 1949, and *The Economic Development of Latin America and Its Principal Problems*, 1950.

<sup>3</sup> Research by Professor Ellsworth, published after the above was written, reveals some serious statistical deficiencies in the terms-of-trade argument. Ellsworth has examined the price record, which runs in terms of British prices—c.i.f. for primary-producing countries' exports and f.o.b. for British exports—over the period 1876-1933.

For the interval 1876-1905, he shows that imported primary product prices fell in Britain owing to the sharp drop in rail and ocean freight rates, but that prices *on the farm* in producing areas generally rose during the same period. Hence, the true terms of trade moved in favor of primary producers rather than against them. Stable price relations characterized primary and manufactured products from 1905 to 1913. The statistical terms of trade moved against primary

all manner of one-sided charges are based on the supposed deterioration in such terms among underdeveloped countries. One such charge even runs to the effect that the principle of the international division of labor is only a doctrine that is designed to cheat the underdeveloped countries out of their proper share of world output.

#### CONTROLLING IMPORTS TO PROMOTE DEVELOPMENT

Something close to a misconception is involved in another argument that is frequently found in the literature. The argument is also implicit in some national policies. Should exchange and trade controls be used to promote economic development by channeling foreign exchange earnings into productive investment rather than allow them to go into consumption? Many spokesmen for the underdeveloped countries answer in the affirmative. There is no question that people denied the right to buy foreign consumer goods will not be able to consume such imports. Superficially, therefore, it appears as if exchange and trade controls serve to expand the total of resources that is available for development (by reserving existing foreign exchange to make payments for capital goods imports).

But it is not clear that the net effect is as indicated. What happens to the domestic monetary demand that is channeled away from imported consumer goods? Will it be used to acquire domestic consumer goods, or stimulate investment in the domestic production of high-cost articles of consumption? If it does the import controls may easily harm the domestic development program, as Nurkse has indicated.<sup>4</sup>

products only during the period 1913-1933, or for much less than half of the sixty-odd years usually claimed by the spokesmen of primary producers. Ellsworth believes that improved quality of manufactured exports can be used to counter this statistical remnant of the argument. See P. T. Ellsworth, "The Terms of Trade Between Primary Producing and Industrial Countries," *Inter-American Economic Affairs*, Summer, 1956.

<sup>4</sup>R. Nurkse, *Problems of Capital Formation in Underdeveloped Countries* (Oxford: Blackwell, 1953), pp. 118-119.

**DISGUISED UNEMPLOYMENT**

Economists are fond of speaking in terms of paradoxes, one of the leading of which relates to the nature of employment in underdeveloped areas. In the United States a man either is employed, on a full-time or part-time basis, or he is unemployed. This distinction is retained in discussions of labor in underdeveloped countries, and in addition there is a new category: people who are at work, or appear to be at work, but who contribute nothing or next to nothing to the nation's output. Such people are said to be disguisedly unemployed. Strictly speaking, they are persons who have a zero or nearly zero marginal productivity; hence, they could be removed or transferred out of existing lines of "work" without being responsible thereby for a reduction of national production.

There is no question that people in some parts of the world are disguisedly unemployed. But all underdeveloped areas are not in fact characterized by disguised unemployment. The phenomenon seems to be limited mainly to some countries in Asia, of which the chief case is India, and to some countries in Africa. Latin America, for instance, though having many people with low productivity, is virtually devoid of disguised unemployment. Hence, it is a misconception to regard such species of unemployment as a necessary feature of underdeveloped areas.

For clarification a distinction must be drawn between people who use primitive means of production (thus showing a low productivity) and people who have a zero marginal output. The former comprise literally tens if not hundreds of millions throughout nearly all of the underdeveloped countries who work with their hands, transport things strapped to their backs, or sell merchandise by squatting all day long beside a mere handful of cheap goods. *Given* the capital supply and the way that most production is organized, such people have no alternative. They don't produce much; but they are at work; they support themselves (after a fashion, to be sure); and national output would decline if they did not remain at their jobs. We in the United States may prop-



erly sympathize with them and show a determination to use practical measures of assistance. But because they are engaged in what is, by United States standards, largely waste motion is no basis for arguing that they are engaged in unproductive effort in the circumstances in which they find themselves. If all the people of the United States had to live and eke out an existence on, for example, an isolated island having the size and characteristics of the state of Nevada, we too would be very numerous in relation to good land and capital and we would certainly show a very low per capita output; the more fortunate peoples in other lands might even regard our case as one of underutilized resources capable of readily being drawn into full production.

This brings us to comment on some misleading implications of views regarding disguised unemployment. The existence of such human resources is thought to provide the countries in question with a strong base from which to launch programs of development. Specifically, it is thought that measures which increase the national money supply and thus expand effective demand will draw such human resources into true production. But what is indicated in the record? For example, could a small fraction, say 5 per cent, of the people working in underdeveloped agriculture be removed without reducing output? Latin American experience shows (a) that in cases in which some labor has been moved out of agriculture—the supply of real capital and methods of production remaining the same—the result has been reduced over-all farm output; and (b) that in every country in which the money supply has been greatly expanded the nation has failed to find any substantial quantity of disguisedly unemployed labor but has instead experienced inflation.

#### **OPERATION ROOFTOP**

Our previously cited data on the structure of employment in Latin America and the United States have shown that a relatively small part of the labor force in underdeveloped areas is engaged in services (or "tertiary" production) and that a very large pro-

portion is in agriculture ("primary" production). Some writers have used data from many nations to run correlations between per capita income and the percentage of the labor force engaged respectively in agriculture, manufacturing ("secondary" production), and services. The purely statistical findings show a direct correlation between the level of per capita income and the percentage of the labor force engaged in tertiary production.

What do such correlations really mean? Some people have interpreted them to mean that the way to accelerate a country's economic development is to devote more attention to expanding tertiary production. Is this not, however, equivalent to constructing a house by first trying to build the roof? If there is a cause-and-effect relationship, it runs from low per capita income to the small proportion of workers in tertiary production. For instance, the relatively few barbers per thousand of the population in an underdeveloped country really reflects low income, and low capacity to pay for services. Clearly, an attempt to multiply the number of barbers before expanding per capita production is tantamount to putting the cart before the horse.

#### **ILLIQUIDITY OF ASSET STRUCTURE?**

Underdeveloped countries are said to labor under the disadvantage of insufficient liquidity. That is, it is held that assets can be converted into cash only with comparatively great difficulties, with the result that there is less than optimum flexibility in the economy. For example, it is pointed out that at mid-century developed countries had bank assets (excluding those of the central bank) equal to about half of their gross national product, but that underdeveloped countries such as Mexico and Guatemala had bank assets equal to only about a tenth of their gross product. If the underdeveloped countries enjoyed a greater measure of liquidity, it is argued that they would show greater factor mobility and increased scope for enterprise and financial operations that serve to expand economic activity.

Many if not most underdeveloped countries are characterized by

financial systems that are not far from embryonic. In fact, the countries would hardly be underdeveloped today if they possessed all of the financial resources, in relation to total output, that are characteristically found in advanced monetary economies. Admitting all this, we are still left with a critical question: are ratios of bank assets to gross national product an adequate comparative measure of national asset structures?

There are several institutional features that must be borne in mind in connection with this question. First, most underdeveloped economies are predominantly agricultural, as has already been indicated. In many of them, moreover, much of the agriculture that is practiced is of the subsistence type as opposed to commercial agriculture in which output is largely exchanged for money. Thus, many economies that show low liquidity in relation to gross national product may nevertheless have a comparatively high liquidity in relation to the size of the commercial sector. Second, paper currency (usually issued by the central bank) is the main means of payment in underdeveloped countries, and not the demand deposit liabilities of the banks. Hence, international statistical comparisons of bank assets exclusive of central bank assets give a distorted picture. Finally, financial transactions proper bulk large in the main developed economies, especially those involving dealings in corporate and government securities, so that bank assets reflect liquidity requirements in the financial sphere and not only the requirements that are most relevant to the growth needs of developing economies. It is for reasons such as these that the illiquidity notions here criticized involve some misconceptions with respect to economic development. Additional support for the critique will be set forth in the following comments on the effects of a declining value of money.

#### **WHAT IS THE CASE FOR INFLATION?**

In most of the instances in which inflation has reared its ugly head it has produced bad economic effects. Despite the rec-

ord, however, a case can be made in principle for *mild* inflation to facilitate capital formation and economic development if the government finds that it cannot get a larger share of the national income through taxation. To see this most clearly, and to appreciate the limitations involved, we may consider a situation that occurs from time to time in developed economies.

The upward phase of a business cycle is characterized by unemployed resources of labor and capital. At such a time compensatory spending by government should be financed not by higher taxation but by way of an expansion of the money supply. There is a risk of some inflation, but the process under circumstances of tested monetary management is one in which the main effect is to put idle resources back to work. It is not until full recovery is nearly achieved that some inflation may threaten, since there is then little slack to take up. At such a stage, however, appropriate monetary management, coupled with the right kind of fiscal policy, usually are adequate to stave off a real inflation.

Thus, the conditions required are that there be truly idle resources which when combined yield useful product on efficient terms. Specifically, idle labor must be combined with idle capital to give the sought-for results. But how much capital is idle in underdeveloped areas? We hear about underemployed or poorly employed labor, but not of idleness of scarce capital. This point is of significance. What, however, if inflation is used to increase the supply of capital?

Inflation in an underdeveloped country may be said to work something like taxation. It may be used to transfer consumer goods to men employed in the formation of capital at the expense of people in the rest of the economy. Prices rise sharply while the physical capital is being created, since consumer goods are now generally short in relation to money incomes. After the capital is created, however, the movement of prices may be reversed, since the new capital contributes to increase the supply of consumer goods.

This suggests that inflation for capital formation eventually becomes self-destructive: it adds as much in due course to the supply

of goods as it does to the supply of money. If capital formation is the sole goal of a policy of *mild* inflation, if the items of capital are well chosen, if taxation is not a reasonable alternative, if the authorities would not try to disguise any inflation by introducing all manner of direct controls to keep the lid on prices, if, in general, the political authorities really would draw the line firmly in the face of pretty certain demands of most cabinet ministries to engage in ever-bigger projects, then there is a chance that the inflation may eventually become self-destructive.

Note, however, the big "ifs" involved. It is precisely because such conditions are seldom realized in practice that it is really a misconception to regard inflation as a satisfactory method of financing development in the typical case. Instead, we find several serious difficulties with inflation in underdeveloped areas. First, it does not materially improve the level or quality of employment. Second, even when there is a formal system of exchange control inflation generates a flight from the currency into safe and stable foreign currencies, thus depriving underdeveloped countries of resources that could be available for their economic growth. Currency instability also has an adverse effect upon domestic savings, further harming capital formation. Third, there is a misallocation of resources, especially in the face of the virtually inevitable government controls over some prices and forms of economic activity that accompany inflations. Goods are fed into consumption through grossly inefficient black markets; inventories are withheld speculatively; price-controlled products, usually "essentials," are underproduced (at the controlled prices), and luxury-type goods selling at high free-market prices tend to be overproduced. Fourth, demand tends to spill over into imports, thus inducing a deterioration in the balance of payments and indirectly worsening the country's chances of attracting foreign capital. The net result is that nations resorting to inflation may wind up foregoing as much as, say, a fifth of their normal output in trying to live with a policy that excessively inflates the money supply. In short, the main trouble with inflation is that it is all too likely to generate development in reverse.

**HOW NOT TO MEASURE THE CONTRIBUTION OF FOREIGN CAPITAL  
TO ECONOMIC DEVELOPMENT**

There is another interesting case with which we may usefully concern ourselves. Economic development is achieved in most countries partly with the assistance of foreign capital. A fact of life is that many nationalists are prone to belittle such assistance or to be critical of its "cost." It is in this connection that we wish to consider the mistaken idea that the contribution of foreign capital to economic growth can be measured by comparing the average annual inflow of new investment into underdeveloped countries with the outflow of earnings and capital remittances. This is the narrow balance-of-payments approach to appraising foreign investment, in which figures selected in a wholly arbitrary manner are used to "prove" a point.<sup>5</sup>

We may illustrate the "factual" argument as follows. Suppose that over a period of five years average annual new investments by the United States in an underdeveloped continent amount to \$400 million, and that there is a \$100 million figure annually for each of the other three categories—reinvested earnings (mainly out of earnings from American investments made in earlier periods), amortization of outstanding debts owed the United States, and interest and dividends received by American investors. The questions before us relate to (1) the size of the underdeveloped continent's "net receipts of United States capital," and (2) the meaning of such net receipts figure.

Those who have pleaded for the underdeveloped areas have claimed, in the type of case before us, that the average annual net receipts of United States capital amount to only \$200 million. How do they "show" this? They simply compare the size of new American investments with the sum of debt amortization plus interest and dividend payments made to the United States [\$400 million — (\$100 million + \$100 million)]. That is, they conveniently ignore the category of reinvested earnings, and thus show

<sup>5</sup> See, for example, *An Economic Program for the Americas*, Report of the International Development Advisory Board, Washington, D. C., 1954, pp. 11-12.

only two-thirds of the true net annual American capital movement to the area.

But this error, though bad (and simple) enough, is not the main shortcoming of the exercise here being criticized. The analysis is also seriously incomplete in its balance of payments aspects. Earnings and remittances for debt amortization are only one category of direct effects that can be attributed to foreign investments. There are other important direct effects that should also be taken into account. For example, foreign investments serve in many cases to expand exports of the recipient countries. They also serve to increase local production of goods that are similar to imports, thus reducing outlays on imports.<sup>6</sup> Neither of these considerations finds a place in the argument under discussion. Yet the two effects are quite important. Together, they could increase the underdeveloped countries' annual foreign exchange earnings or reduce their outlays on imports by a sizable fraction of the reported annual payments to American investors on interest and dividend account.

One more point. There are also important indirect effects on the balance of payments of underdeveloped countries. Thus, foreign investment often stimulates local enterprises to greater and more productive efforts, introduces some changes in the distribution of incomes locally, widens economic opportunities, helps to train local personnel in a variety of technical and semi-technical jobs, introduces a number of innovations in production and business organization, increases social mobility, and so forth. In sum, the case shows how unsatisfactory it is to try to describe the grin in the absence of the cat.

## PROBLEMS

1. "The problem of economic development is one of changes in motivations, institutions, and techniques—changes concerning which the existing body of economic theory has nothing to say." *Evaluate.*

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<sup>6</sup> We may cite an interesting illustration. The Frigidaire, produced by General Motors in Brazil, contains 230 parts, of which 139 were imported in 1951, 62 in 1953 and only 4 in 1956. There are countless cases of this type in the record of import-displacing local production, involving both domestic and foreign investments.

2. "Economic development does not depend simply on the availability of capital, still less on capital from abroad." *Explain.*

3. "Underdeveloped countries having abundant surplus agricultural labor need concern themselves with nothing but ways and means of using such labor in capital formation." *Evaluate.*

4. "Despite the mountain of literature on development, no author has asked why the demand for capital is low in technically static economies." *Explain.*

5. "Harm may result from attempts to impose on underdeveloped areas a rate of development that exceeds the rate at which the local social structure can adapt itself." *Explain.*

6. "The failure of Soviet agriculture, after several decades of trial, shows that the Russian peasant, like any other, wants goods and not rubles." *Explain.*

7. "Many underdeveloped countries are being caught up in the 'demographic explosion' which follows a successful attack on primitive death rates." *Explain.*

8. "The history of advanced industrial countries traces out the road of development for the more backward countries." *Evaluate.*

9. "Arranging countries in order of size of their development gaps would indicate each nation's possibilities in terms of its own attainable development maximum. There is little meaning in saying that an adult rabbit is 'underdeveloped' because a baby elephant is so much bigger." *Evaluate.*

10. "It is not meaningful to call the Sahara 'underdeveloped' because Holland is a garden." *Explain.*

11. "Free economies devote too much investment to consumer goods industries; hence, it is necessary to have a planned economy on the Soviet model to assure maximum development by investing heavily in new output-capacity to serve the needs of future investment programs." *Evaluate.*

12. "Even though comparisons between Soviet and Western growth rates of aggregate production raise a multitude of insoluble statistical problems, and Russian levels of living remain far below the American, Soviet levels may still make a favorable showing to visitors from underdeveloped Asia: Tashkent and Alma Ata are an impressive contrast to Tabriz, Kabul, and Rangoon." *Explain.*

13. "The need to husband water in semi-desert underdeveloped countries shows that farmers in newly irrigated areas of such countries must become 'tenants of the government.'" *Evaluate.*



14. "Underdeveloped nations need only adopt a collectivist approach if they wish to achieve the take-off into self-sustained growth." *Evaluate.*

15. "The international division of labor is bound to shrink as economic development occurs in more and more countries." *Evaluate.*

16. "To say that the problem of production is solved and that we need only concern ourselves with the problem of distribution is to utter a nineteen-thirtyish fallacy." *Explain.*

17. "If Western economics abstracts unduly from economically relevant social facts, Marxist economics relies unduly on social fictions and hence is deceptively misleading with respect to many problems of economic development." *Explain.*

18. "To claim that inflation undertaken for productive purposes is reliably self-liquidating is to beg the whole question whether projects and their timing can be rationally planned without a reliable unit of account." *Explain.*

19. "To our generation of Indian students, brought up on Lord Keynes, it is obvious that the United States lacks investment opportunities sufficient to absorb her annual savings; hence underdeveloped countries do America a favor by maintaining employment in the United States when they receive economic aid." *Evaluate.*



## CHAPTER 24

# Domestic Policies of Developing Economies

This chapter deals with actions designed to force the pace of economic development. Such actions are primarily those that governments pursue or may adopt as national policies. In this field of activity, as in any other in which progress is being hurried, there are bound to be pitfalls that beset efforts to accomplish much in a short span of time. How may such pitfalls be avoided? We shall see that economic analysis offers some guidance of a general kind. After considering a few guideposts, we shall deal with a variety of practical measures that are likely to play a useful role in accelerating the growth of underdeveloped areas.

### INDUCED VERSUS SPONTANEOUS GROWTH

We have said that this chapter is concerned with measures to *force* the pace of economic growth. This is also known as “induced development.” It contrasts with spontaneous economic growth, or development that occurs as the result of the uncoordinated actions of thousands and millions of individual producers. There is hardly a country in the world whose development now occurs solely on a spontaneous basis. Historically, America’s development was largely spontaneous, but even we made extensive use of railway grants of

land to accelerate the vital transportation phase of our national development.

The issue is how to blend induced and spontaneous elements. If the Soviet pattern is followed, this issue is resolved by disallowing any spontaneous actions and leaving everything to a centralized and ruthless bureaucracy. There is no question that Soviet nonagricultural development has been considerable. In fact, the pace of Soviet economic growth is faster than our own. But it has been well stated that no other political-economic system could have starved the population quite so effectively. In this connection, it is an ironic postscript to the Communist Manifesto that the workers of Hungary today have nothing to lose but their chains. Their rebellion against the Russians in 1956 shows that they prefer death to life under communism, the world's most "induced" form of economic development.

Most forms of induced development outside the Soviet orbit consist of long-range government actions to create basic service facilities—roads, schools, irrigation projects, port facilities, and so on—in order to broaden the economic base and thus expand opportunities in the private sector. Some industrial operations may also be undertaken by the government, in steel as a rule. In such cases the observed growth of the economy reflects both induced and spontaneous factors. Thus, India's first five-year plan, which is of the mixed type of development, achieved its objectives. The case of Brazil is also worth mentioning, partly because it illustrates development processes in which induced factors are relatively less important than in a country such as India. Brazil has developed vast mineral and water resources, established a large government-operated steel mill (to supplement privately-operated mills), modernized some of its railways, and witnessed a great industrial concentration in the state of São Paulo.

There is no question that deliberate government intervention for development has been effective in many cases, despite errors and handicaps. But the road ahead is not smooth and easy.

### INVESTMENT CRITERIA

As compared with a country such as the United States, an underdeveloped nation possesses relatively little capital and relatively abundant labor. Clearly, an underdeveloped country should economize in the use of scarce capital. How far can it go in pushing the use of labor? Since labor is not in infinite supply, and hence socially costless, there are economic limits to the use of this factor as a substitute for scarce capital even assuming that there are no technical obstacles to such substitution.

#### SOCIAL MARGINAL PRODUCTIVITY

Putting the problem in this way suggests the first question: when should a country stop substituting the plentiful factor for the scarce? The most general answer is that the substitution should stop when the social marginal productivity of any factor is the same in the various uses to which it may be put. At such a point no further gain in national output may be realized by using more labor in relation to capital in any one use as compared with any other. (The concept of social marginal productivity takes account of the net contribution of the marginal input to national product and not merely that portion of the contribution which may accrue to private investors. For example, in a region without electric power, or with only modest amounts of it, a new power plant will have a social marginal productivity greater than its private marginal productivity by virtue of the plant's contribution to such things as (a) reduced theft resulting from the advent of street lighting, and (b) lower production costs in factories able to avail themselves of lower cost power from a central source. Or the private marginal productivity of investment in, say, a copper smelter is higher than its social marginal productivity because the latter takes account of the damage which noxious gases inflict upon vegetation in the surrounding area.)

**SOME QUALIFICATIONS**

National output may be said to be at a maximum when resources are allocated by equating the social marginal productivity of each resource in its various uses. Standing by itself, however, this principle of resource allocation is only a bald statement. It is tantamount to a look only through a keyhole into a large room in which complex activity is taking place.

For instance, a nation may maximize its national product by consuming, say, 105 per cent of its gross national product in every period for a number of periods. Does this lead to development? Of course, it leads only to a running down of the economy's capital plant. Clearly, maximizing per capita consumption in the case of an underdeveloped economy is not the policy that will raise per capita output in the long run. A nation cannot concentrate on consumption as an immediate goal and still realize development as an ultimate objective.

There is an even more serious objection to make about the maximizing of national product as an objective of policy. If all goods were consumer goods and short-lived capital goods, maximizing national product would represent a reasonably clear-cut thing. But much of a nation's output consists of long-life capital goods. The value of newly produced capital goods depends on the value of the stream of output that is generated by such goods. In the nature of the case, we cannot know what the future tastes of the people will be, nor the size and composition of the population, nor the state of the arts, and hence we cannot know what the value of future output will be.

Moreover, something must be known about the comparative economies of scale of the different industries in which investments may be made. Industries with increasing returns to scale will produce a rising stream of physical output, while industries showing constant returns to scale will show a steady output per unit of investment. Over the long run, the increasing returns industries will make a greater contribution to national output than constant returns industries.

The time-pattern of future output must also be taken into account when dealing with additions to capital. This pattern is partly dependent upon the development of skills, the growth of markets, and the progress that is made in overcoming production bottlenecks. Some investments could result in additions to capital that required few new skills, that were based on existing small markets, and that left existing production bottlenecks about as they were. Such investments do not make anywhere near as great a long-run contribution to national product as investments which involved new skills, for example.

#### **THE UPSHOT**

What is the upshot of the present discussion of the criteria for investment in underdeveloped areas? We first stated the general principle of social marginal productivity and then proceeded to indicate several important considerations that would have to be borne in mind in applying the principle. But we have not been able to set forth a knife-edge definition of an all-inclusive principle. The upshot, thus, is that we do not have an alternative to the idea of social marginal productivity as a general guide to the correct allocation of resources and especially of scarce capital. This principle should be so interpreted as to give the benefit of doubt to capital goods (1) that promise increasing economies of scale and (2) whose existence is likely to encourage the development of skills and growth of markets. So interpreted the principle may play a useful role in guiding thinking about the cumulative and dynamic process of economic growth.

The principle must be applied by policy makers, for example, to such difficult practical investment-allocation problems as the following: investment in agriculture versus investment in industry; within agriculture, the commercial versus the subsistence sector; within industry, light versus heavy industry; as between sectors of the economy, plant and equipment versus education and public health; and geographically, the capital city versus the hinterland. Unfortunately, the necessary statistics are seldom available in the

typical underdeveloped country. Hence, the problem of allocating investment must be met by relying mainly on personal judgments that are necessarily subject to substantial error.

Compare this situation, however, with the alternative—the usual political decisions. Such decisions generally result in even grosser errors of public policy. For instance, they often neglect the subsistence sector of agriculture, pay little attention to capital investment in human beings, unduly emphasize heavy industry, overdo public investment in and around the capital city, and rely excessively upon the stimulus of inflation.

### **SOCIAL OVERHEAD CAPITAL**

There is one broad category of public investment that stands out above all others in economic significance. We refer to social overhead capital—roads, some power plants, irrigation projects, educational facilities, and the like. Such investments, or most of them, are of an eminently public nature: they are basic requirements of growth but they are of a kind in which the private investor lacks interest because, in the nature of the case, he is unable to capture the lion's share of the fruits of the investment.

The allocation of resources for the formation of social overhead capital should be governed by the rule of social marginal productivity, interpreted in the broad sense that has already been indicated. One element in such an interpretation is the matter of external economies.

Perhaps the main economic rationale for social overhead capital is that it provides all manner of individual producers with important external economies. For example, roads that give an agricultural region access to markets enable individual farmers in the region to expand their output while realizing declining or lower unit costs of transportation. Similarly, once an area has an electric power plant electricity-users are able to buy the power they need at declining or reduced costs per kilowatt-hour. Electric power production is more involved than most people realize, and hence it probably should be produced on a public basis only when failure has attended



sincere efforts to obtain private capital for the job. If the educational system is geared to turn out qualified people in vocational arts, expanding firms needing such trained personnel can count on obtaining more proficient recruits at any given level of wages and so may actually realize lower labor costs per unit of output than they could expect in the absence of a system of vocational education.

Thus, investment in social overhead capital tends to spur existing private producers to expand the scale of their operations, to attract new producers to the area affected by the investment, and to improve the quality of their productive effort. In short, public investment that is allocated according to the broad rule of social marginal productivity itself expands and improves economic activity. In the process, there is set off an economic chain reaction which—if associated with carefully considered reforms in the incentive-structure of the community—could yield impressive cumulative results.

#### **A CRITICAL MINIMUM EFFORT?**

Before we proceed in the present section, we should deal with an issue that crops up in the literature on economic development. We refer to the question of speed. If economic development is really to "come off" at all, some writers believe that investment in social overhead capital (as well as private investment) must occur at a rapid pace. According to one version of this position a modest total of small-scale investments scattered over the landscape probably will not be suitable by the time they yield their fruit: they are likely to be appropriate only to a pre-development situation. Another version is that there must be a marked rise in voluntary saving to maintain the momentum of development, but that this growth of saving is not likely to occur unless the national income rises steeply. A steep rise in national and per capita product, which requires a large burst of investment, permits some expansion of consumption, but such expansion is not likely to absorb all or most of the increase in product; hence, there probably will be a marked rise in voluntary saving. In contrast, when there is a slow growth of per capita output

people are supposed to improve their level of living imperceptibly and bit by bit in line with the slowly increased availability of goods—thus consumption tends to overtake and dissipate the expansion of output.

Is it really a case of high-speed development or no development at all? If it is, we should expect the historical record to show that levels of living adjust rapidly to increased productivity. The Japanese record does not show such an adjustment; nor does that of Western Europe. Moreover, there is the question of the appropriateness of the allocation of investment. High speed may result in a poor allocation of investment resources, in which case there would be a canceling out of the advantages of large-scale effort. The risk of poor allocation is especially great inasmuch as many underdeveloped countries have neither the requisite number of trained and experienced technical and administrative personnel, nor adequate governmental machinery with which to program operations in the economic sphere, nor a tradition of suitable relations between officialdom and the private sector of the economy. In addition, social adjustment in cases of rapid economic change may proceed sluggishly and disruptively—as recent experience in Indonesia shows. Poor social adjustment in turn may even undermine the existing slow pace of economic growth. Finally, a policy of high-speed growth is likely to increase the chances of serious inflation.

What is required, then, is not necessarily high speed—the attainment of which is questionable even if it is sought—but systematic and persistent action along many fronts. Each action, small and large alike, should re-enforce all others in snowballing fashion. Thus, the second period should see the emergence of a broader and stronger economic foundation than that which existed in the first, there should be a stronger base in the third period than in the second, and so on for each succeeding period. It is not necessary to conform to a pre-arranged blueprint to achieve growth. The method of trial and error, in which regular use is made of the broad rule of social marginal productivity, should amply reward countries that show a patient determination to get ahead economically.

### THE PRE-CONDITIONS

The formation of social overhead capital on a solid basis imposes several requirements. One relates to knowledge. In most underdeveloped countries the requisite statistical material and other information is either inadequate or nonexistent. There usually are usable data on commodity import and export trade, the national government's budget, the prices of staple export products, and the operations of the central bank. But there is as a rule little else that is usable in connection with the allocation of investment. Thus, it is necessary to undertake a wide variety of empirical studies: on the structure of the economy; the size and composition of the labor force; the use of resources in agriculture and the yield of such resources on both national and regional bases; the factors that account for the existing level of productivity in agriculture; the location of industry; economic performance of industry, especially in relation to tariff and other forms of protection; agricultural and industrial credit and its adequacy or inadequacy; the level of savings, its distribution by income-groups, the factors which affect its volume, and the most effective means by which savings may be increased; the whole area of entrepreneurship; tax policy and the relationship of taxation to inducements to effort; the nature and extent of government regulation of business and an assessment of the impact of such regulatory activities on the pace of economic growth; and so on.

A second pre-condition, which probably should not await the completion of detailed studies, concerns domestic savings. It is absolutely essential that an early, vigorous, and systematic effort be made to expand the marginal rate of saving in order that (a) there may be a maximum of capital formation out of any given level of domestic income, and (b) there be the broadest possible base from which to achieve future economic expansion of national product. As far as domestic factors are concerned, there is probably none which limits capital formation more than the low level of savings. In this connection, it may be pointed out that incomplete evidence shows that some nine-tenths of an underdeveloped coun-

try's capital formation is usually financed in one way or another by domestic savers.

The key role of domestic savings in the development effort should be thoroughly appreciated by policymakers and all necessary actions taken to maximize voluntary savings. The requisite actions will differ from country to country, owing to national differences with respect to political stability, the protection accorded to property, stability of the currency, the scope of opportunities for the private use of capital, the social importance of economic standing in relation to other bases of status, attitudes relating to equality and inequality of incomes, and so forth.

If the record shows anything, it is that nations usually do not induce a high rate of voluntary saving simply by campaigning for it in anything like the way in which political parties solicit votes. Rather, conditions favorable to savings are created slowly, roughly in the way that traditions are created. This means that no time should be lost in getting down to the job of establishing the necessary conditions and getting the savings ball rolling.

A third pre-condition is essentially educational. Economic development requires that there be substantial capital formation of a human sort. A trained engineer or an animal husbandry specialist is as much an embodiment of capital as reproducible wealth in the form of a mechanical drill press or semi-automatic lathe. There are few such people in underdeveloped areas, while many are needed. Each country's educational plant must therefore be expanded and staffed to do a much bigger job in the many specialties that are required for a vigorous program of social overhead capital formation (as well as for over-all economic expansion).

Finally, it is necessary to establish a good relationship between government and the private sector. If this is started, or if possible attained, before the program of social overhead capital formation is well under way it should serve to induce a maximum private interest in and support for the program itself. Energizing the forces in the private sector is important for many reasons: it should provide backing for the program, accelerate educational planning by the youth who are thus made more vividly aware of new horizons of

opportunity, expand business saving and encourage nonbusiness saving as well, attract foreign private capital, and improve the appeal of a career in management in relation to the appeal of the other professions.

#### **WHERE'S THE MONEY COMING FROM?**

There are of course the financial aspects of social overhead capital formation. In the last analysis, such capital formation requires not money but real resources—steel, cement, technical personnel, and the like. These resources somehow must be transferred to the government, but the transfer must proceed in such a way that the important private sector of the economy is not deprived of resources that are necessary for its growth.

What resources does the government have, or what resources may it tap? Clearly, a government's resources under a policy of noninflationary finance are limited to those which it may obtain by way of taxation and the borrowing of savings. How far should the government go in taxing its people? How far should it proceed with borrowing? Such questions, as we shall see, are easier to ask than to answer. Real statesmanship will be required of the top officials of developing countries. (A statesman, incidentally, is a politician who does difficult things.)

To get some perspective on the nature of the financing problem, let's consider a suggestion that has been made by some economists. Foreign loans and domestic savings, it has been held, are available in reasonable volume only to countries that are already in an advanced stage of development. Regarding loans from abroad, it has been said that foreign lenders are unlikely to invest in a country before that nation's own capitalists push forward with investment. Thus, it is pointed out that United States private capital prefers Latin America to Asia, and Canada to Latin America. In this connection, it may be mentioned that the behavior of United States private capital contradicts the Marxian line, according to which capital in developed countries is forced to seek investment in underdeveloped areas in order to maintain the prevailing profit rate at

home. The fact is that United States capital prefers to remain at home where in most cases investment opportunities are more attractive.

Domestic savings, it has been held, are likely to be utterly inadequate in underdeveloped countries because such nations have feudal political and economic structures and the masses of the people eke out only a mere subsistence. Thus, there are supposed to be few possibilities of inducing people to save in such countries—the poor can't and the wealthy won't because they are busy imitating the consumption habits of high-income people in the advanced countries.

As a result, so the argument runs, the underdeveloped countries have no choice but to rely almost entirely on taxes for the financing of development. We are told that there is ample scope for increasing taxes in the underdeveloped countries, as is indicated by the fact, for example, that income taxes in the United States are higher than in most underdeveloped countries that employ this kind of tax.

Let us examine the tax argument critically. First, however, it may readily be admitted that the underdeveloped countries should be able to obtain greater resources for development by way of increased taxes. But for most countries these taxes probably would not consist of income taxes, in view of high illiteracy rates and the fact that few people keep books on income. Increased tax revenue probably would have to come largely from higher taxes on luxuries and a progressive tax on property.

The financing of development almost entirely by way of higher taxes means that the burden will fall mainly on the nation's most enterprising sector and the group which does most of the saving. What will be the effect on incentives to produce, innovate, and save if there is a sharp and substantial increase in this group's taxes? The answer will vary from country to country, depending on circumstances. If an ambitious tax-financed program is introduced in a country in which tendencies toward (1) nationalization and (2) government operation of businesses have been real, sharply increased taxation of the entrepreneurial group is likely to weaken the private sector by as much or more than the program improves

the public sector. If, on the other hand, increased taxation is announced as part of a broad-gauged program which is enterprise-oriented except for the tax aspects, the entrepreneurial group may have net favorable long-term expectations, in which case private saving is likely to fall by an amount less than the increase in taxation. In the latter case, moreover, inducements to efficiency need not decline, despite a temporary drop in the rate of private capital formation. Another alternative must be mentioned in connection with the latter case: the financing of social overhead capital formation by way of more moderate taxation coupled with government borrowing is likely to produce a situation in which the total contribution of government and the private sector to development will be greater than that which results when the government relies on taxation to finance its program. There is so much that has to be done to accelerate development that government policy must not fail to include all feasible positive measures to encourage a maximum effort in the private sector.

#### **THE CAPITAL-OUTPUT RATIO**

A logical sequel to discussion of the mode of financing social overhead capital formation would be to indicate orders of magnitude with respect to capital requirements. We might ask ourselves, "What is the relation in money terms between a given amount of desired annual output and the capital that is necessary, on the average, for its production?" The answer is given in the form of the "capital-output" ratio, which, though general, nevertheless gives an idea of capital requirements with respect to social overhead capital formation.

The capital-output ratio is found in the statistical record. For example, it is believed in underdeveloped countries that it requires about \$3-4 of capital on the average to make possible a \$1 increase in annual production. The capital-output concept thus serves the important purpose of emphasizing the great role of investment in economic growth.

To illustrate, if the annual rate of population growth in under-

developed countries amounts to 2 per cent, it will be necessary to absorb an increase of 6 to 8 per cent of the gross national product just to keep per capita income from falling. Alternatively, if population remains stable while 6 to 8 per cent of the national product is used in capital formation, it may reasonably be expected that annual per capita product will increase about 2 per cent.

International differences in the capital-output ratio are significant. Specifically, the ratio is lower in underdeveloped countries, principally because labor is plentiful in relation to capital, than it is in advanced economies. And within an underdeveloped country, the capital-output ratio usually is lower in agriculture than in, say, manufacturing.

The comparatively low capital-output ratio is of interest in connection with the significance of relatively low investment rates in underdeveloped countries. For example, investment rates of some 5 to 7 per cent of gross national product prevail in Southeast Asia, as compared with rates of 16 to 17 per cent in the United States and Canada. If investment rates in some underdeveloped countries are only about a third as high as those in developed economies, does it follow that the position of underdeveloped countries is as unfavorable as these figures suggest? If we refer to comparative capital-output ratios we see that the answer is in the negative. Specifically, the amount of new investment required to raise output by a given amount is a good deal less in underdeveloped countries than in advanced industrial nations, where very capitalistic methods of production prevail.

Though the capital-output ratio is an interesting concept, attempts to use it empirically are likely to prove rather difficult in many cases. This is because what is required is that rarity in underdeveloped areas—good statistical data. It is necessary, for example, to know the ratios that have been realized in the past, the extent to which these ratios have been stable, whether or not historical ratios may appropriately be extrapolated, and the usefulness of national income accounts for capital-output analysis. To be specific, it is necessary to have conceptually comparable wealth estimates for a number of dates, and income estimates for the same dates. Income



and wealth series should go back a long time, because it is necessary to have dates that are far enough apart in years so that the probable margin of error in the estimate of capital and income for each selected year is small in relation to the increment in capital and in income between the years. But the data as a rule are so inadequate, especially with respect to the size of the aggregate capital stock, that the statistical margin of error is likely to be rather high.

There is another point that needs to be made. The capital-output ratio, even if based on excellent statistics, should not suggest that the stock of reproducible producers' goods and equipment is the only thing that is decisive for economic growth. Other factors are also important. High on the list, for example, is the quality of the human factor in production—the skills of the labor force and the efficiency and quantity of entrepreneurial activity. Also important are the effectiveness of social and political institutions in facilitating and encouraging economic activity, and the quality of natural resources.

### **ACTION IN THE PRIVATE SECTOR**

We have seen that measures in the field of social overhead capital formation, though necessarily of a public nature, act powerfully to accelerate development in the private sector. But there is much else besides social overhead capital formation proper that is called for with respect to the growth of agriculture and industry in the private economy. It is to this area of discourse that we now address ourselves.

#### **AGRICULTURE VERSUS INDUSTRY**

As has already been indicated, most of the labor force in underdeveloped countries is in agriculture. Sometimes the share is as high as four-fifths, but one-half to two-thirds is more common. People of low productivity who are on the land cannot be moved bodily off it. In the short run this is because there would literally be no place to go. Industrialization may properly be regarded as a major

objective, but it is a goal that can be achieved only slowly. (In some underdeveloped countries agricultural development may offer as much long-term promise as industrialization.) In the meantime, worthwhile results are sure to be achieved if there is considerable emphasis in policymaking on the improvement of agricultural productivity so that (1) higher levels of living might be attained by the multitude of this generation's farm people and (2) a big impetus may be given to expansion of the domestic market.

Expansion and improvement of agriculture is not always well regarded by vocal opinion in underdeveloped areas. Such people, who are anxious to industrialize rapidly, would de-emphasize agriculture especially when a large part of the labor force works on the land. However, these people are likely to be ignorant of or forget the rule of social marginal productivity. The simple truth is that the social marginal productivity of investment in agriculture is likely to be relatively high in many cases. As we have already shown, the rule of social marginal productivity can guide officials who make decisions with respect to the relative emphasis to be placed on expansion in the different economic fields.

#### PROGRAMS IN AGRICULTURE

Underdeveloped agriculture suffers from the widespread use of pre-modern practices. Illiterate men on tiny and scattered plots of land, the absence of seed selection, lack of control over insects and plant and animal diseases, poor soil preparation and the absence or insufficiency of fertilization, limited efforts in agricultural experimentation, backward animal breeding, and poor credit and marketing facilities are characteristic features. Important increases in productivity may be realized rather quickly if each of the soft spots is dealt with energetically by men genuinely interested in improving the welfare of poor farmers.

It is possible to consolidate many landholdings that are now scattered; farmers can be taught methods of seed selection and assisted in acquiring good seed; insecticides can be supplied to expand yields; deep plowing can be practiced and improved drainage sys-

tems used; fertilizers may be made available; governments may introduce new or expand existing agricultural experiment stations with staffs that are suitably trained and adequately rewarded; inbreeding of livestock may be replaced by scientific practices to produce animals that are best suited to each region so as to assure optimum use of available feed and fodder; farm credit may be expanded and made more accessible to farmers now isolated because of poor roads; and marketing practices can be improved to increase the farmer's share of consumer expenditure on his output. In dealing with each of these cases it is almost a certainty that the individual farmer's self-interest can be enlisted to get the necessary cooperation if programs are well formulated and implemented by men who earn the goodwill of farm people.

There are two main vehicles by which the relevant knowledge may be imparted to farmers. First, well-tested systems of agricultural extension are available (and in use in some underdeveloped countries). The extension agent, a trained man, is the link between the experiment station and agricultural college or ministry on the one side and the dirt farmer on the other. His personal contacts with knowledge-hungry farmers, discussions with them, the distribution of simply written scientific literature, and other means of demonstrating superior practices are one of the principal keys to expanded farm output in underdeveloped areas. Though the United States has perfected agricultural extension work, the mechanical and unimaginative employment of our methods will not necessarily give good results in backward economies. When suitably adapted to the local situation, however, there is much that the underdeveloped world can learn from our rich experience. In this connection, technical assistance programs (so-called Point Four operations) which the United States carries out jointly with the local ministry of agriculture in many countries have already done much to get backward agriculture off dead center.

A second vehicle is closely related to the first. We refer to systems of supervised credit. The position of credit is strategic with respect to innovation in backward agriculture. If credit institutions can impose planting and production conditions on the farmer—in the

borrower's own interest—it is possible greatly to accelerate the growth of farm productivity. In essence, this system is agricultural extension coupled with a bankroll. The farmer who seeks credit, and who is not practicing good agriculture, may be granted credit only if he agrees to carry out a production program that is best suited to his land and other resources and requirements of the market. An agricultural technician first surveys the farmer's operation and then lays out a program, tailored to the farmer's situation, that is consistent with the broad framework established by agricultural policymakers and the (official or private) lending institution. The technician then makes periodic visits to each farmer-borrower to check on performance and render technical advice and otherwise assist the farmer. Though a more costly method of extending credit than those which do not use supervision, the system has generally been well received by backward farmers and it usually has been responsible for productivity gains that have more than justified the costs involved. There is great need for more widespread use of supervised credit in underdeveloped countries.

But missionary work may well be a prerequisite in many cases. The simple fact is that many public officials have long used their position to exploit poor farmers, for example, by occasionally appropriating chickens or a hog. As a result, farmers not uncommonly hide their livestock whenever they hear that public officials are about. Clearly, it will be necessary to eradicate such practices on the part of officialdom if the most is to be made of the potentials of agricultural extension and/or supervised credit.

### **INDUSTRIALIZATION**

Since underdeveloped people's industrial aspirations have been realized so slowly there is more than a presumption that the problems of industrialization are of huge proportions. Yet we are not entirely in the dark, nor is there a paucity of advice. The communists and their propaganda apparatus, for example, never tire of telling the world that there is the Soviet model for all to follow. But if ever there was a cure that would be worse than the "disease,"

youth of the socio-economic bases for differential rewards and the connection between such a tested system of rewarding effort and national economic growth, appropriate emphasis in educational policy on (1) facilities for educating young men in modern technology and (2) the long-term advantages of training for business as compared with the traditional professions and the military, and a redesigning of government operations especially in the collection and dissemination of business statistics so as to render a much-needed public service to the private economy.

There is another matter that deserves special attention, partly because it is a case that is ideal for joint action by government and industry. We refer to the widespread phenomenon of undermaintenance of private and social capital in underdeveloped areas. For example, roads are often allowed to run down for lack of periodic repair; and plant and equipment are in poor condition in many cases for want of regular maintenance. The result is that physical capital which can readily be kept in a high state of efficiency through relatively modest annual expenditures on maintenance wears out prematurely and thus requires capital outlays two to three times as large as the aggregate annual expenditures that would be entailed under policies that called for regular maintenance. Clearly, undermaintenance represents a serious waste of capital in countries in which capital is the scarcest of resources.

It is possible to outline a number of other joint government-industry actions, over and above those already mentioned, that might be taken to accelerate economic growth. One more may usefully be indicated. We refer to the desirability of developing local capital markets, especially the expansion of facilities for and public interest in the provision of equity capital. At present, a typical prospective industrialist limits the planned scope of his operation either to the capital that he personally owns or can borrow from relatives and friends or this amount plus capital that he might borrow from outside sources on a loan basis (so-called "debt-capital"). Such borrowings involve fixed interest charges. In contrast, capital obtained in equity form involves variable charges (which may, however, involve higher costs over the long term).

Thus, an active and efficient local capital market affects the kinds of costs that a business incurs. Typically, there is substantial uncertainty with respect to new business ventures in underdeveloped countries. It is easier to adjust to the unexpected the lower the ratio of fixed charges to total costs. To illustrate, if a new business would have \$100,000 of annual fixed charges if it uses debt-capital but only \$50,000 of such charges if a part of the capital is equity capital, it will be better able to act under conditions of uncertainty when it is able to obtain equity capital. Other things equal, the business could also be of larger proportions, perhaps, more closely approximating optimum size. Hence, business opportunities which may be exploited with capital a high proportion of which involves variable charges would attract more potential enterprisers than would like opportunities that are exploitable only with debt-capital.

### PROBLEMS

1. "Priority for agricultural development in many underdeveloped nations may actually represent the most rapid, even if indirect, method by which to achieve lasting industrialization." *Explain.*
2. "Development requires capital in a sizable lump, and not through marginal increments that result from a set of individual-enterprise decisions; hence, Western, and specifically American, experience is of no avail." *Evaluate.*
3. "Feudal attitudes toward entrepreneurship will disappear if trade and industry provide a route to the top of the social scale." *Explain.*
4. "Since Soviet economic growth in recent decades has been at a faster pace than America's, the Soviet model should be followed by underdeveloped countries." *Evaluate.*
5. "In underdeveloped economies total output is virtually inelastic in the short run." *Explain.*
6. "The problem of progress is an exercise in managing or husbanding scarce resources." *Explain.*
7. "The study (of Nigeria) implies that the revenues and expenditure of the government represent simply net additions to resources for development, without stating that they are derived from the private sector. It is indefensible so to neglect the effects of taxation on output." *Explain.*

8. "Most underdeveloped countries' exports are so notoriously unstable that the countries cannot plan suitable development programs." *Evaluate.*

9. "The inadequacy of technology and capital may be due less to a shortage of information about techniques or of potential savings than to shortages of the 'right' kinds of institutions—'right' implying those kinds of institutions which permit or stimulate, rather than impede, the adoption of new techniques and the formation of productive capital." *Explain.*

10. "Indian legislation which involves maintenance-of-employment requirements tends to make labor a fixed rather than a variable cost with a corresponding adverse impact on entrepreneurial calculations." *Explain.*

11. "The practice, common in the Philippines, India, Pakistan, and other nations in the area, under which the tenant bears all the costs of land improvements although he must share with the landlord any resulting increase in output, restricts incentives to innovate." *Explain.*

12. "Asia's joint or extended family system, with its shared rights and obligations, is another example of institutions deterring economic growth." *Explain.*

13. "Recent land reform proposals in the Philippines stress adjustment of average, rather than marginal, crop-sharing ratios in favor of tenants. Desirable on grounds of equity, the stimulus to productivity would be greater if the adjustment were confined to the marginal ratio." *Explain.*

14. "The marked preference in India for careers in government and education rather than business enterprise or engineering illustrates a status-oriented behavior inimical to maximum development." *Explain.*

15. "It is foolish for Western economic development advisers to believe that 'alien' institutions are transmissible." *Evaluate.*

16. "Abundance as standard of living and abundance as pace of progress are not the same thing." *Explain.*

17. "The Indian government's first function is to provide the external economies without which economic development is not possible." *Explain.*

18. "A difficulty is that many nations engage in unnecessary capital expansion in fields only tangentially connected with development." *Explain and, if possible, illustrate.*

19. "If the kettle of inflation is perpetually on the boil, there is not much hope for real development." *Explain.*







## Development and International Investment

Economic development has to be paid for. And among the payments none figure more prominently in national programs than those connected with the financing of the foreign components of local projects. It should be noted at the outset, however, that the foreign financing phase of the general problem of growth in underdeveloped areas is only a part of the field of international investment. Long-term capital continues to move in fairly large volume as between the advanced countries: United States investment in Canada admirably illustrates this point. Nor are foreign financial requirements always met from investment proper. Foreign aid is also a part of the picture—in a controversial sort of way. There may also be mixtures of conventional foreign investment with straightforward financial aid, and even combinations in which conventional foreign investment may occur with a blend of commercial and aid-financed agricultural surplus disposal programs. Finally, finance may be provided through regular private channels in the case of foreign investment, through governments bilaterally in the case of foreign investment and/or aid, or investment and/or aid may be carried out multilaterally through international agencies, special-purpose and general.

### THE GENERAL PANORAMA OF AMERICAN FOREIGN INVESTMENT

Perspective may be had by seeing the picture in the large, from a vantage point within the United States. Thus, American companies develop Labrador's or Venezuela's iron ore so as to offset dwindling supplies of high-grade domestic ore; our automobile manufacturers establish branch plants in Canada, Brazil, and so forth; oil companies probe and make investments all over the free world to keep up with the persistent growth of world demand for petroleum products.

Then there is the field of foreign investments made by our government—which have been undertaken for a variety of purposes in the national interest. For example, the government has invested in the development of its own Manila hemp plantations in Central America in order to have a nearby and strategically safe source of supply of this strategic commodity. The government has also made large loans to other governments for broad purposes, an example being the \$3.75 billion loan to Britain just after the last war which in effect continued lend-lease in another form. We may also cite the government's Export-Import Bank of Washington, which is a large foreign lender whose purpose is to assist in financing exports and imports and the exchange of commodities between the United States and foreign countries. Finally, we may mention the Department of Agriculture, which sells surplus farm products to other countries on a long-term and intermediate-term loan basis and in local currency as well as in terms of dollars.

There is also the large international financial institution, the International Bank for Reconstruction and Development (IBRD or "World Bank"). This is located in Washington and draws mainly on American funds, but is owned and operated by nearly 60 governments including our own; it makes hundreds of long-term loans, large and small, for everything from specific roads to complex multi-dimensional national development programs, using capital obtained mainly by the sale of its own debentures to private investors.

Thus, there are all manner of private and public foreign investments, totalling billions of dollars, in which the nation participates. Our position is pre-eminent in the field. A century ago, however, few would have dared to predict that such a state of affairs would have come to pass, with the United States at the heart of a complex global process of capital formation. At that time, as is generally known, Britain held the center of the stage.

We may also point out that a country's capital exports may give rise to types of investment which represent different legal claims. Briefly, there are two classes of foreign investments: direct and portfolio. The former are those illustrated by the foreign subsidiary of an American concern or the foreign branch plant. More generally, American foreign direct investments are those in which the American home office has control or enjoys marked participation in control by virtue of stock ownership. Portfolio investments are those in which Americans are creditors while foreigners exercise enterprise or other control as such. Bonds are the classic illustration of portfolio investment. Incidentally, most American foreign investments are of the direct type.

### TECHNICAL ASSISTANCE

Foreign services as well as foreign-made equipment are involved in real international investment. We now wish to concern ourselves with an important kind of such services—so-called technical assistance. A fairly important role in economic development is played by technical assistance. What is this phenomenon? Congress has defined it in the Mutual Security Act as "the international interchange of technical knowledge and skills designed to contribute primarily to the balanced and integrated development of the economic resources and productive capacities of economically underdeveloped areas."

The design, establishment, and implementation of an agricultural extension program in a friendly country which had previously been without such an arrangement is one illustration of technical assistance. Clearly, such a program is no different in principle from agricultural extension work that has been carried out for decades

within the United States. We do not call the domestic version technical assistance, but this is the way the foreign product is now tagged. We do not seek to establish and then run such a program forever, let us add. On the contrary—success is measured in part by the speed with which we help to set up an organization, locally staffed, which is capable of taking over completely and conducting an efficient and useful operation entirely on a domestic basis. In short, technical assistance in, say, a given country's agricultural extension work is intended as a "self-liquidating" project as far as American participation is concerned. Similarly, there are technical assistance programs in public administration. These are designed to accelerate the development of efficient and well-organized ministries of agriculture, for example, thus hastening the growth of agricultural productivity. Technical assistance is also rendered in the field of public health, say, by employing experienced technicians to reform and modernize ministries of health and thus assist poorer countries in developing norms and practices that will reduce the incidence of disease. And so on with respect to a number of service aspects of economic development.

We may say that technical assistance (TA) as just described is the "official version," that is, the kind undertaken on an intergovernmental basis. There are also other types, some of which have an illustrious history. Thus, direct investments usually carry with them technical know-how. For example, a five-man team of Texas geologists who work as a firm under contract with a major oil company to explore for oil in the jungles of a Latin American republic employs technical knowledge and skills which contribute to development. The team may also train native personnel in some of the less technical phases of the work, so that there is a training dimension as well. In the meantime, promising native youngsters may go abroad to take university work in geology and petroleum engineering, returning to join firms such as our Texas geologists. In due course local technicians should be able to take over completely. This kind of technical assistance is admittedly important, and American firms—as well as those of other nationality—have been doing much of such work for a long time. But we shall not at this

point emphasize assistance which is a by-product of direct investment. Instead, we shall concentrate on the official variety.

Technical assistance other than the official variety has not been provided only by companies with foreign direct investments. Non-profit organizations, as typified by religious missionary institutions, have also been in the picture for decades. They too have contributed technical assistance, especially in the fields of education and public health.

Various national and international institutions are engaged in rendering technical assistance for economic development. Thus, the United States government's Point Four program—so called because it was announced to the world as the fourth point of an American program for peace—is a well-known arrangement. This operates bilaterally; that is, our government enters into an agreement with other governments, one at a time and with terms tailored to each situation, to undertake TA programs on a shared-expense basis. The United Nations also has a TA program, for which financial contributions are made by member governments. This is called a multilateral program, in that a government which signs an agreement does so with the United Nations as such. Actually, such programs are also bilateral agreements—between an underdeveloped country and the United Nations; but the term “multilateral” is used to contrast an international-agency-operated program with the Point Four type of arrangement. There are also regional TA programs, such as those of the Colombo Plan countries in South Asia and those of the Organization of American States in Latin America.

Problems of coordination arise from time to time. This is because a given country may have as many as three or more separate TA programs in operation within its borders: Point Four, United Nations, and Colombo Plan or Organization of American States programs. Most of the coordination is done in the budget-making process. Thus, before budgets of the separate programs are approved (insofar as the same government is involved with one or more of such programs), the contributing governments usually screen or examine proposed programs so as to eliminate unjustified duplication.

**MAGNITUDES**

Global technical assistance amounts to something over \$200 million a year, as may be seen in the following table which summarizes results since 1950 under the Point Four, UN, and OAS programs. Comparable data are lacking for the Colombo Plan program, but it is known to be smaller than the UN effort. It will be noted that Point Four represents the biggest activity, which actually is much larger than indicated because the figures shown refer only to the United States share of the Point Four effort.

TABLE 25 1

POINT FOUR, UNITED NATIONS, AND ORGANIZATION OF AMERICAN STATES  
TECHNICAL ASSISTANCE PROGRAMS, 1950-56  
(in millions of dollars)

Year	Point Four* (fiscal year)	United Nations		Organization of American States	
		Amount <sup>b</sup>	Percentage Contributed by the U. S.	Amount	Percentage Contributed by the U. S.
1950	4.8	19.9	60%		
1951	34.4			1.3	70%
1952	137.2	18.7	61	1.1	67
1953	138.9	22.1	58	1.2	66
1954	105.1	24.4	57	1.4	69
1955	105.0	28.0	54	1.6	70
1956	127.5	—		—	

\* United States share only, that is, the amount appropriated by Congress.

<sup>b</sup> Figures refer to the UN program's central account, thus excluding contributions which recipient governments make toward the cost of special UN projects within their own countries.

SOURCE: *Technical Assistance and Related Programs*, Report of the Senate Committee on Foreign Relations, Washington, D. C., 1956; the International Cooperation Administration; and the Organization of American States.

**REGIONALISM: THE COLOMBO PLAN**

We should supplement the above discussion of technical assistance with a few words about one of the best known regional ar-

rangements—the Colombo Plan for Cooperative Economic Development in South and South-East Asia. This arrangement, dating from 1950, resulted from a conference of Commonwealth Finance Ministers in Colombo which met to seek ways and means of speeding the development of the area. The original membership—Australia, Canada, Ceylon, India, New Zealand, Pakistan, and the United Kingdom—has since been expanded to include non-Commonwealth countries such as Burma, Cambodia, Indonesia, Japan, the Philippines, Thailand, the United States, and Viet-Nam.

The members draw up multiyear development and technical assistance programs, consider problems of financial assistance from the outside and ways and means of increasing domestic financial resources, and consult about policies and programs. Outside financial assistance is provided mainly by Britain, the United States, Australia, and New Zealand. The British assist by making investments (for example, partly through the Commonwealth Development Finance Company, a joint British industry-British government entity) and releasing substantial sterling balances which some of the area's members had accumulated during the last war. The United States helps mainly by making government grants of aid on a bilateral basis, by carrying out TA programs jointly with local governments, and by way of programs sponsored by the Ford Foundation. Australia and New Zealand make more modest contributions in roughly similar ways.

Technical assistance is arranged in large measure through the Technical Cooperation Scheme of the Colombo Plan. This permits the exchange of TA on a coordinated basis between participating countries. In addition, Point Four and UN technical assistance representatives attend and participate in meetings of the Colombo Plan organization. The Plan's work is also coordinated with the research and related efforts of the Economic Commission for Asia and the Far East (which includes UN members not located in the area). Finally, the Colombo Plan group maintain liaison with the World Bank.

Agriculture and community development projects receive major attention; but mining and fishing also come in for a good share of



TA. In each of these fields, the emphasis thus far has been mainly on training technicians, disseminating technical knowledge relating to production, and carrying out experiments in agriculture and mining. New training facilities have been provided, complete with local and foreign experts, and programs have been devised to expand opportunities for technical study abroad. Typical benefits have been the following: (1) South India has accelerated the efficient exploitation of substantial lignite deposits through pilot excavation efforts, drilling work, and de-watering tests. This effort has improved the country's available fuel resources and has also taken some of the load off crowded internal transport since coal is not mined in the area. (2) TA has been used to coordinate programs so as to have experts and equipment work together at the right time. For example, Ceylon's low protein diet has been improved as the result of the mechanization of fishing craft, experimentation in trawler fishing, and the cooperative marketing of the increased output on a refrigerated basis. (3) The Commonwealth Livestock Research and Demonstration Farm in West Pakistan is another case, which has helped to increase the number and improve the quality of cattle and sheep. The yield of wool alone has been increased as much as 200 per cent.

#### **NATIONAL INTEREST<sup>1</sup> AND TECHNICAL ASSISTANCE**

Congress has been appropriating funds to finance Point Four work and parts of each of the other technical assistance programs that have been discussed above. What is the American stake in technical assistance (or technical cooperation, as it is also called)? In broad terms, our interest is in a politically stable and economically expanding free world and in international arrangements that facilitate the carrying out of our foreign policy and promote the

<sup>1</sup> The term "national interest" as used here and elsewhere in this chapter is not to be confused with nationalism and narrow self-interest. Briefly, other countries have no moral claim on America's energies and resources. Hence, we should make available our resources on a gift basis only when the national interest is served thereby. It is not served, for example, when recipient governments are

national interest abroad. By sharing some of our technical knowledge and trained manpower (often with minimum supplies of equipment) with other friendly countries to accelerate their development, we facilitate the conduct of our foreign policy.

In the words of the Senate Committee on Foreign Relations, "The economic development of underdeveloped countries is in the interests of the United States if it proceeds within the framework of a reasonably free society. . . . Technical assistance is only one of a number of instruments available to the United States to carry on its foreign policy," the others being "economic aid, military assistance, security treaties, tax and commercial treaties, overseas information programs, participation in the United Nations and other international organizations, the exchange of persons program, tariff and trade policies, surplus agricultural commodity disposal policies, and the traditional processes of diplomatic representation."

Apart from the general value of technical assistance as an instrument of foreign policy, the work also has significant trade and other effects. It is a fact, for example, that our trade is much greater with developed than with underdeveloped countries in per capita terms. Thus, our exports in 1954 amounted to \$182 per Canadian, \$40 per Dutchman, and \$13 per Briton, but to only \$2 per Iranian and a mere 43 cents per inhabitant of India. Our trade should expand as the poor nations develop themselves. Nor is TA necessarily a one-way street. Thus, American technicians have found foreign plants that are good additions to our agriculture, such as a native grass of Iran which is suitable for use in South Dakota; and specialists in public health have encountered foreign problems and acquired experience which may be very useful in dealing with unexpected difficulties that may strike us at home.

How large our over-all TA effort should be is, of course, difficult to specify. Given the dimensions of the combined defense-foreign

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corrupt and foreign citizens realize that our aid would help to line the pockets of hated officials. It is served when we make and retain friends abroad, when we strengthen the position of democratic elements in friendly foreign countries and weaken the position of totalitarian factions therein, and so forth.

relations effort which is being and will long have to be undertaken in the national interest, and the magnitude of the service-job connected with the economic development of friendly underdeveloped areas, it would appear that the existing effort errs on the low side. For instance, the United States spends about \$8 million for each heavy bomber (with spare parts). Such a comparison, to be sure, does not necessarily prove the case for an expanded T/A effort. Technical assistance probably merits greater American participation for another important reason: the whole process is one that identifies us with progress and with local people who occupy key roles in the national effort to accelerate economic growth. Our technicians, without any specific political ax to grind, mingle with local people and budding local technicians and work as a team to improve production and welfare.

In many cases, the technicians are representative faculty people from our universities, under contract with the United States government, who work with the economically and technically progressive elements of local society. Such men, as 'shirt sleeve ambassadors,' are well qualified to help keep before other peoples the values for which America stands. In a world menaced by the clever actions and subversive efforts of totalitarian states, we need more and not less of the kind of thing technical assistance represents.

Should an increased effort be made along Point Four lines or through the United Nations? There are many voices that urge the latter course. But there is reason to believe that the Soviet bloc will become increasingly active in the UN technical assistance effort. Though we cannot tell when the zig of Soviet policy will become a zag, it is questionable whether the national interest will be served by a greatly expanded UN effort in which Soviet participation, unlike the situation to date, is substantial. To be on the safe side, therefore, it is probably best (1) to "beef up" the Point Four program, but only in individual national cases where it is clear that the local government and people demonstrate a healthy *attitude* toward their own problems, and (2) to increase our contributions to regional arrangements in which a greater American effort would be desirable.

### LARGE-SCALE AID FOR DEVELOPMENT

Before we proceed, let us nail down an important point that has been implied in the preceding two chapters and the above discourse on technical assistance. It is this: growth of the underdeveloped countries, though now in the process of being accelerated, is essentially a slow and unspectacular process that affects most segments of society and its institutions. To be sure, there may be a few spectacular features in the development of some countries—such as a giant dam across the Nile, a big steel mill in a country of some size which did not previously have such a plant, a nuclear power station, and so forth. But such projects are the exception to the broad rule, which calls for unspectacular items of the order of technical training institutes here and there, grain storage bins, expanded savings, reform of government administration, roads where only trails exist, agricultural experiment stations, and the like.

Awareness of the slow and unspectacular process is important for more than one reason. It means that success is likely to be dependent to a great extent on wide public understanding within underdeveloped countries of the underlying forces that produce real development; in the United States and other donor countries it means that it will not be easy to marshal continued public support in behalf of large foreign development-aid programs—even if we assume that a good case can be made in principle among the well-informed opinion leaders for such efforts. In this connection, it is perhaps instructive to remember that the President has not found it easy to win annual congressional support for our military-economic aid programs, the nature of which our public regards as much more clearly in the national interest than economic development as such.

With this by way of background, let us proceed to the controversial subject of large-scale grants-in-aid for economic development. We shall build our discussion around SUNFED, the proposed Special United Nations Fund for Economic Development.

•SUNFED is meant to be a fund for grants-in-aid and long-term

low interest loans to underdeveloped countries, with more emphasis on aid than on loans. According to a United Nations report on the matter, it is proposed to make a beginning on a relatively modest basis. Thus, it has been proposed that the fund should not be established until a minimum of \$250 million has been pledged by at least 30 nations. A few European countries have indicated their desire to join others in establishing such a fund, and to work for an operation of very large proportions, but the United States, Britain, and some other European countries have made their support contingent on the achievement of world-wide supervised disarmament.

It goes without saying that the underdeveloped countries have an obvious interest in a large-scale grant program for economic development that would draw mainly on the resources of a relatively few advanced countries—as far as foreign requirements are concerned—but be administered by an international agency in which they have a majority voice. Hence, the following discussion will pay special attention to the American interest in a large-scale United Nations aid program.

By a large program is meant one running to several or more billion dollars annually, or something of the order of the average military-economic aid program that the United States has conducted since the last war. For example, some Americans have suggested that we offer to contribute 1 per cent of our gross national product—or about \$4 billion a year. Interestingly, it is uncertain how much America's regular military-economic aid program (in which the economic component is largely for what is called "defense-support") may safely be reduced if there is a large UN development-aid program, at least in the early years and until the Communist Empire radically curtails its expansionist aims. Moreover, American pronouncements on development aid have come thus far from the Executive Branch and not from Congress.

It is generally understood in responsible American circles that the United States has an important stake in promoting economic development abroad. For example, this is the view of the influential businessmen's Committee for Economic Development (a body that concerns itself mainly with domestic economic policy); which

regards American assistance toward development abroad as an investment in our national security and in our future growth and prosperity. Such groups realize that the diverse underdeveloped countries have some things in common, one being that vocal people among them are becoming increasingly aroused against the poverty which has been their traditional lot. Such people are eager to improve their material development. It is believed, moreover, that it is on this eagerness and discontent that communism feeds. The turmoil in the underdeveloped world, it is also thought, can be channeled for good through accelerated economic development.

Another fairly common view is that America was motivated to help Europe with Marshall aid for much the same reasons that now call for aid to more than half the world's people who live in underdeveloped areas. There are parallels, to be sure. But the Marshall program really was quite different. We wished to speed the recovery of countries that were largely devastated as a result of a common war effort. The recipients of aid were advanced nations having a civilization akin to ours, and we could count on results over a few years. Marshall aid helped to *restore* a tested socio-economic pattern. The job of accelerating development is far harder, slower, and more uncertain. We cannot assume that the energy and dynamism of the West will rub off on the people of underdeveloped countries, at least not at a visible pace, for the true problems of economic development revolve around profound changes in motivations, institutions, and techniques. We cannot assume, moreover, that mere improvement in their material condition will make the people hostile to communism and insistent upon working for freedom and democracy. In short, we cannot assume that large-scale, internationally administered development-aid will channel the revolutionary forces in the underdeveloped world in directions compatible with our security interests. This is not to argue against wise generosity; but neither can we forget to be vigilant.

There is also a big question about the suitability of the United Nations as the vehicle through which to channel large-scale grant aid. This institution was established as an agency to maintain political peace, a continuing and obviously important task. It is doubtful

whether the machinery of the UN is appropriate for handling a large grant program, since the UN is essentially a forum for hearing and settling international disputes and not an institution with a structure and organization that is suited for substantial and continuing *executive* functions. (The observer who once remarked that an international agency has as many bosses as country members wasn't too wide of the mark.)

What, then, can the United States do to help speed economic development abroad, in addition to carrying out an expanded bilateral technical assistance program? There are several things. Through its treaty program, the United States government can work to improve the investment climate in the underdeveloped world. Our private long-term foreign investment in underdeveloped countries is about \$500 million a year (net). But this amount is small. Investment treaties can help to expand it. The main needs for capital in poor countries are for social overhead capital. In many nations this is a category that is not now attractive to private investors, but investment treaties could work to improve investment opportunities in some types of social overhead capital, partly by reducing nationalistic hostility to foreign business.

At present, we reduce by 14 points the corporate income tax on income earned from investment elsewhere in this hemisphere. This could be made applicable to all foreign investment income. We could also consider effecting a greater reduction.

Expanded loan activities by the World Bank and the Export-Import Bank are also necessary. Every practical measure should be taken to enlarge the outflow of capital through such tested institutions, whose standards insure that resources for development are used with maximum efficiency in soundly conceived projects.

However, are the underdeveloped countries likely to obtain enough foreign capital for accelerated economic development when we have exhausted every avenue for expanding private foreign investment? It is doubtful if they will. We are thus faced with the question: is it in our national interest to use public funds to meet the deficiency? Many thoughtful Americans believe that it is. But they want such investment to be selective—focusing in the

main on the critical countries of the underdeveloped world, concentrating chiefly on the creation of basic social overhead capital such as transportation and water resources, and using loan financing in most cases rather than grants. The emphasis on loans is based on experience which shows that grant assistance, if long continued, tends to demoralize relations between donor and recipient. To the limited extent possible, our agricultural surpluses could be used as a substitute for either public loans or grants (we discuss the details below).

### **AN IMAGINATIVE WAY: USING FARM SURPLUSES TO FINANCE DEVELOPMENT**

The Food and Agricultural Organization has taken the initiative to think through the possibilities of using some of the world's farm surpluses to finance a part of economic development programs under selected real-world conditions. Is there a more sensible use of surpluses which are regarded as "burdensome" in producing nations?

An Indian "pilot study" was conducted to show the possibilities of using farm surpluses to finance development programs in addition to those which otherwise could be carried out. What are the necessary conditions? The main ones were found to be: (1) the existence of unemployed or underemployed labor which could be put to work constructing new facilities or otherwise acting to expand future productivity; (2) projects requiring substantial labor and using mainly domestically produced materials; (3) a sufficient number and variety of administrative, technical, and supervisory staff to program new activities; (4) projects the carrying out of which would expand domestic incomes relatively slowly; (5) the existence of farm surpluses that are wanted by people in the recipient country and available, while they last, on special terms from surplus countries; (6) the demand for the surplus products must be such that the receipt of such commodities would not depress domestic production of like or directly competitive items; and (7) some supplementary foreign financing should be available to round out programs that would be financed mainly by the use of surpluses.



Under these conditions a part of the total cost of an expanded Indian development program could be paid for through receipts from the sale in India of surplus farm products. The country would first accumulate some of the surpluses in national reserves. Then, as it disbursed funds on an expanded development program of the right kind it would be on the look-out for signs of inflation. The programs would involve paying out incomes without at first expanding consumable output to a proportionate extent—hence the probability of an inflationary movement of prices. As such price effects began to manifest themselves, or threatened to do so, the authorities would release and sell in the domestic markets enough surpluses drawn from the reserves to mop up money income which would otherwise continue to inflate prices.

There would be difficulties to guard against, of course. Perhaps a major one would be the effects of spending some of the increased incomes on imports. Hence, not all the inflationary effects could be checked by releasing surpluses. Supplementary financing would be needed to pay for the increased imports, especially if the developing country is to avoid making excessive use of direct import controls. Clearly, there seems to be a case for the use of agricultural surpluses to spur economic development under some conditions that are found in part of the underdeveloped world.

### THE WORLD BANK

We turn next to a most successful institution, the International Bank for Reconstruction and Development, popularly known as the World Bank, which began operations in 1946. Designed during the last war, at the same time that the experts were drafting the provisions of the International Monetary Fund, the Bank has gone on to achieve an enviable record in contrast to the case of the Fund.

When the Bank opened its doors the world economic situation was dark. The war had seen to that—devastation of productive facilities, disruption of normal trade patterns, and serious international tensions dominated the global scene. But the nations got

to work, aided partly by government-to-government loans, then grant aid, and the resumption of long-term international lending. It is with regard to the last-mentioned factor that we now address ourselves. The lending has not only continued but has been expanding.

#### STRUCTURE AND ORGANIZATION

The World Bank has played a large and constructive role in the complex problem of international capital formation. Its nearly 60 member governments belong to an institution with the following dimensions: there is an authorized capital of \$10 billion, divided into 100,000 shares of \$100,000 each. Subscriber capital now amounts to over \$9 billion. The United States subscription is \$3.175 billion, and in the order of size the next four largest subscribers are Britain, China, France, and India.

The total subscription is divided into two parts: (1) 20 per cent constitutes the Bank's own loan fund and is subject to call as follows: at the start, countries are required to pay two per cent of their subscription in gold or United States dollars. The remaining 18 per cent is payable in each member country's own local currency; (2) 80 per cent of the total subscription, not paid to the Bank until actually needed, is to be used to guarantee obligations of the Bank itself—that is, its own bonds. The 80 per cent, thus, is a kind of reserve against losses. When losses have to be met, countries will be subject to call to cover such losses. Each country will be able to pay, at its option, either in gold, in United States dollars, or in the currency in which the obligation is payable.

There is a three-level organization of the Bank's management. The Board of Governors deals only with broad issues, and is made up of one governor (usually the finance minister) from each member nation. They meet once a year for a few days. At the intermediate level is the Board of Executive Directors, of which there are 16 who meet weekly in Washington, the Bank's headquarters. The five members with the largest subscriptions have their own

payable in sterling at the option of the debtor, debt service in sterling must equal the dollar value of the payments contracted for at the time the loan was made.

Experience has shown that the Bank has had "18 per cent trouble." In fact, the president has had to complain on more than one occasion that some members have violated the spirit of the agreement setting up the Bank by withholding their 18 per cent mainly for commercial policy reasons—that is, to have borrowers make equipment purchases outside the dollar area by withholding funds from the Bank, whose regulations permit borrowers to spend the proceeds of loans in any country in the world. Some European countries have been the worst offenders, as the following table shows.

TABLE 25.2

USE OF THE WORLD BANK'S 18 PER CENT CAPITAL SUBSCRIPTIONS, JUNE 30, 1955  
(in millions of dollars)

<i>Region</i>	(1) <i>Used or Allocated to Existing Loans</i>	(2) <i>Total 18% Capital</i>	(3) <i>(1) as a Per- centage of (2)</i>
United States and Canada	\$624.9	\$630.0	99%
Europe	133.6	586.8	23
Latin America	0.2	60.5	—
Africa	5.8	28.1	21
Asia	—	283.6	—
Australasia	—	36.0	—
Totals	\$764.5	\$1,625.0	47%

SOURCE: World Bank, *Tenth Annual Report*, Washington, D. C., 1955, p. 14.

We turn next to discuss the Bank's main source of loanable funds. This source is the private capital market. Again, however, the Bank may lend borrowed funds only when it has obtained the approval of the country in whose markets the funds are raised. Once the approval has been received, the currency is fully convertible into other currencies. Thus, the country which lends to the Bank does not have continuing control over withdrawals of funds by the borrower from the Bank. Moreover, loans from bor-

rowed funds that are outstanding and payable in any one currency cannot exceed the amount of the Bank's own outstanding borrowings in that currency. Thus, if outstanding borrowings by the Bank *in dollars* total \$100 million, the Bank cannot have outstanding loans payable in dollars in excess of this amount—over and above the 20 per cent of the American subscription which is freely available to the Bank. The reason for this provision is that it assures countries that are short of dollars that they will not have to obtain that currency in such a way as would weaken their exchange position, since the extra dollars would not really be needed to make payments in the United States. The rate of commission on loans from borrowed funds shall be between 1 and 1½ per cent annually on the outstanding sum during the first ten years. The rate has been at 1 per cent, and it has been continued beyond the indicated period for reasons of financial prudence, since it is a source of reserves which may be used to meet losses.

The Bank has floated bond issues in several countries, but mainly in the United States. Canada has ranked second, Switzerland third, Britain fourth, and the Netherlands fifth. Most of the funds have cost the Bank 3 to 3½ per cent. Most borrowers from the Bank, in turn, have paid from 4 to 5 per cent, including commission. This is low-cost borrowing to the underdeveloped member countries, where long-term interest rates usually are not far from twice the amount charged by the Bank.

We may include a word about the geographic distribution of loan expenditures. During the first nine years, about three-fifths of the funds borrowed from the Bank have been spent in the United States, a third in Europe, and small proportions elsewhere. But Europe is now drawing up almost to parity with the United States.

#### HOW LOANS ARE MADE

What is the procedure by which the Bank makes a loan? A typical case would be about as follows. First, an application is made to the Bank for a loan, following which Bank officers make



a preliminary investigation at headquarters. If this investigation indicates that the application has merit, the Bank will inform the applicant country that it wishes to investigate further.

Second, the Bank usually sends a technical mission to the applicant country. As a rule three technicians from the Bank's staff are sent—an engineer, an economist, and a third person especially qualified to deal with the technical nonengineering aspects of the proposed project. Thus, if an irrigation project is involved, the third person will be a specialist in water conservation and use. The technicians study only the technical aspects of the loan. The economist, for instance, reports on the condition of the general economy and on the nation's repayment capacity—the report on the latter being as a rule an analysis of the way in which the project is likely to permit an expansion of exports or a replacement of imports. After the technicians study the proposed project on the spot, they return to Washington headquarters, where a full report is prepared.

Third, the report is submitted to the president of the Bank. He and his staff then make a careful study of the project in the light of the technical report and Bank policy. The technicians usually are questioned at length by the Bank's officers. As to policy, only one aspect can be indicated in this book: the Bank's policy is to make loans only for productive projects. There may be many meritorious projects, such as those which seek to improve the health of laborers, but these do not qualify at present because they do not facilitate debt repayment as productive projects do. When a decision is made by the president and his staff, it is presented to the executive directors for final action. The directors may act on a loan directly, but their practice is to act only after a proposal has been submitted by the president.

Fourth, if a loan is made, there is important follow-up machinery. This phase of the loan, known as "end-use supervision" calls for the use of Bank inspectors in the borrowing country. The inspectors see to it that the materials and equipment bought with the proceeds of the loan are used for the specific purposes set forth in the loan contract. No longer can a nation borrow to build a

railroad only to use the funds to build an amusement park or for handouts.

#### **THE INFLUENCE OF THE BANK**

The World Bank is helping to achieve several desirable objectives. In combination, the attainment of these ends is vitally necessary to the satisfactory development of international economic relations.

First, it is helping to establish reasonable interest rates and other loan conditions. As we have seen, the Bank cannot make loans if these can be obtained from private lenders on reasonable terms. Borrowers are helped in that they can go to the Bank when others do not offer reasonable terms. The Bank may also adjust repayment terms if really necessary. Thus, it may extend the length from, say, 20 to 22 years, depending on the merits of each case. But the Bank also has to impose safeguards. In fact, it has been accused of imposing conditions and has agreed with the accusers. There is no other way of avoiding serious setbacks. Thus, the Bank agreed to finance the modernization of Thailand's government-owned railway system, but on condition that it be set up as an autonomous agency free from any government interference. In other cases, the Bank has refused to consider loan applications until the country has reformed its ways and stopped an import spending spree. Such a spree absorbs foreign exchange that had been considered in previous loans as necessary for servicing obligations to the Bank. Moreover, sprees of the indicated type are unneighborly: they may lead to defaults, which might spoil the Bank's credit and thus its ability to borrow funds with which to continue lending for development.

Second, it is helping to develop the balanced growth of world trade. It does this by several means. One consists of looking at the over-all economy of the borrower, to make sure that any one project fits well into a broad pattern that will eventually lead to self-sustained growth. Incidentally, the Bank's many country studies indicate how this is done, and also provide a wealth of information

on economic development. Another way in which the Bank helps is to train people, which it does in its Economic Development Institute. Finally, it requires the borrower to find enough local capital to meet local expenditures for labor and materials.

Third, the Bank helps to develop multilateral trade and investment. It does this mainly by permitting the borrower to spend the proceeds of a loan in any country. This is in contrast to the procedures of the Export-Import Bank of Washington, a government institution, which makes *tied* loans—those in which the proceeds must be spent in purchasing United States products or services.

Fourth, it is helping to create an international stake in the regular servicing of loans. Members provide the Bank with capital and also agree to share losses. The latter is the thing we wish to mention here. Each member country is liable for its proportionate share of losses up to the size of its subscription. Hence, each member has a stake in every other country's having a good repayment record. It is wholesome to have such a distribution of the risks of international lending.

Finally, the Bank is helping to promote sustained high-level international lending. It does this through insistence that nations submit sound projects and by demonstrating to investors that the Bank is worthy of their confidence in placing savings with it. With respect to projects, it has given principal emphasis to basic public service facilities. Thus, its development loans have been ranked by category as follows: electric power, transportation and communications, agriculture and forestry, industry, and general development.

### THE INTERNATIONAL FINANCE CORPORATION

As we have seen, the World Bank is required by its charter to make loans only when they carry a government guarantee. In many instances, however, foreign business entities with basically good prospects have not been able to avail themselves of the Bank's resources simply because they have not deemed it advisable to obtain a government guarantee. We need not attempt to catalog

the reasons for opposition to such guarantees—they are varied and usually solidly based on political realities (some areas are underdeveloped partly because the realities to which we refer are so distinct from their American counterpart).

In any event, the World Bank's rich experience has shown that economic development would be accelerated if there existed an international financial institution which could provide capital without a government guarantee. Such an institution was created just about a decade after the Bank opened its doors for business. We refer to the International Finance Corporation (IFC), an affiliate of the Bank, capitalized at the modest sum of \$100 million. However, the IFC should prove to be much more significant than the size of its initial capital suggests. We may add that the new institution, though affiliated with the World Bank, does not have the same country membership.

The IFC was conceived as an agency that would supply venture capital as well as loan capital. But as finally approved it was not permitted to invest in foreign businesses (preferably industrial) by buying equity securities as such. Instead, it will invest in the debentures or other senior securities of productive undertakings in association with private investors in cases where sufficient private capital is not available on reasonable terms. But it will not hold such investments indefinitely, or plan to do so—rather, it will *revolve* its capital by selling its holdings to local or foreign private investors as soon as it can consistent with the welfare of the firms in which it originally invested. Thus, the IFC may buy, say, convertible income debentures of the XYZ Car and Foundry Company of Country X. These amount to 25 per cent of the Company's total capitalization, let us suppose, and would provide a source of income to the IFC only when such income was earned by the Company. The other 75 per cent of the Company's capital would be held by private investors. After three to five years the Company may well be so firmly established that private investors in Country X or in other countries may wish to purchase the IFC-held convertible income debentures. (Convertibility would enable such buyers to obtain common stock—a type of security that the



IFC is not allowed to hold.) Thus, the IFC would revolve its capital. That is, it would have sunk some of its funds in the Company, but would recover such funds after a relatively short time on a flexible basis, so that the funds become available for investment in another productive private undertaking. This would go on case after case. Clearly, the IFC may play an important role as a catalytic agent, drawing on the immense prestige of the World Bank—with which it is affiliated—to win local support for policies and governmental actions that are conducive to the expansion of the enterprise sector. If, after demonstrated success, the IFC should need additional capital, there is every reason to believe that it will obtain it on favorable terms. (It has the power to borrow funds.)

The need to promote the enterprise sector merits additional comment. IFC activity will consist of more than the provision of capital to promising firms in underdeveloped countries. For example, as suitable opportunities for productive investment come to its attention, it will seek to recruit capital from private sources domestically, and, if necessary, to find experienced management. But the IFC itself will not participate in management. In general, it will seek to stimulate and help create conditions which will stimulate the flow of both domestic and international private investment into productive enterprises in IFC member countries. We should not be surprised if the results, in their variety and scope, greatly surpass initial expectations.

### THE EXPORT-IMPORT BANK

One of the largest long-term lenders is the government's own Export-Import Bank of Washington. In fact, at the time of writing its loans aggregated a larger sum than those of the World Bank.

The Export-Import Bank was established in 1934 as a depression agency designed to accelerate exports and thus help to spur our economic recovery. It took on special war-connected functions during the last war. Since then it has made long-term loans mainly for purposes of economic development. Its lending authority amounts

to \$5 billion, the funds in question being obtained when needed by borrowing from the Treasury. The Treasury also holds the \$1 billion of capital stock of the Bank. As of the end of 1955 its record could be summarized as follows (in billions):

Loans authorized	\$7.4
Cancellations and expirations	1.4
Disbursements	5.1
Repayments	2.4
Loans outstanding	2.7

Incidentally, because of its small staff and the nature of its operations the Bank is extremely efficient—its administrative expenses run to only 1.6 per cent of gross income.

The Export-Import Bank also has its operations coordinated by the same interdepartmental financial committee—the NAC—that scrutinizes and passes judgment on World Bank lending. That is, before loans are made by either organization, the NAC instructs the United States representative involved, an official of the Export-Import Bank or the United States executive director on the World Bank, concerning the government's policy in the matter.

Export-Import Bank loan principles may be set forth in succinct form. First, it extends loans, guaranties, or financial assistance in other forms to promote our export and import trade when such trade cannot be financed through normal commercial channels. Second, loans are made only for specific purposes as a rule, and disbursements occur only when there is evidence that the purposes of the loan have been or are being carried out. Third, loans are made only when there is reasonable assurance of repayment. Fourth, loans are almost always made only to finance purchases of United States equipment or the technical services of American firms.

The Bank's direct loans take the form partly of purchases from an exporter without recourse upon him of a part of the notes or acceptances of a foreign importer received by him in connection with an export sale. They also consist of loans to an American or foreign firm or government for purchases of American goods destined for a foreign project. The guaranties extended by the Bank cover all the risks of repayment or only those connected

with dollar transfer or other specified risks. It may be added that the Bank assumes that credit for periods of less than a year may be obtained privately on reasonable terms.

As compared with the World Bank, it may be said that the Export-Import Bank's lending is more closely geared to American foreign policy objectives. That is to say, the Export-Import Bank's loans have a greater political dimension than do those of the World Bank. But this is only a generalization—the exact situation cannot be revealed short of a complete examination of a long record.

Geographically, most of the Bank's outstanding loans as of the end of 1955 were to underdeveloped countries (if we exclude the large loans to France). Thus, the amount for Latin America was \$0.9 billion, Asia \$0.3 billion, Africa \$0.1 billion, while Europe excluding France had a net debt to the Bank of \$0.5 billion.

### **SOME PROBLEMS OF FOREIGN INVESTMENT**

We conclude with a brief discussion of a few key problems in the field of international investment and the role of such investment in economic development. What do we learn from the past, and particularly the great period of foreign investment in the nineteenth century? Does a net outflow of capital from the advanced countries contribute resources for the development of underdeveloped countries or is the outflow required to be of some minimum dimension before this purpose may be achieved on a good scale? Can the expansion of per capita income in underdeveloped countries be made self-sustaining without further increments of net foreign capital? What about the problem of eventual repayment?

#### **THE NINETEENTH CENTURY**

In the modern period the nineteenth century qualifies as the heyday of foreign investment. Britain was at the center of the stage. Today, in America, there is still a feeling of nostalgia for the nineteenth century environment that made possible such in-



vestment. What was the situation at that time? Can the environment be re-created?

An important point is that Britain exported capital at an astonishing rate for over 50 years before 1913. The rate, in fact, was some 4 per cent of her national income. In terms of recent American income levels, we would have to make foreign investments of some \$15 billion a year to equal Britain's earlier performance. Actually, our foreign investment rate has been only a small fraction of this amount. Hence, one feature of the British record is the sheer size of her foreign investment.

Another feature is found in the nature of the recipients of British capital. Her investments went not to the densely populated areas with native civilizations often of an ancient kind—largely today's underdeveloped areas—but to the "regions of recent settlement." These were temperate regions of spacious, fertile, and almost empty plains: the United States, Australia, Canada, and Argentina.

Thirdly, the exports of capital were correlated with a heavy migration of Europeans to the areas receiving the capital. Many of the migrants were trained and enterprising people who had grown up in a capital-minded milieu and thus were culturally prepared for the use of Western equipment and techniques.

Fourthly, the capital-receiving nations which expanded their production were assured of ready markets for their exports in the capital-supplying countries and especially in Britain itself. Repayment was thus facilitated by liberal import policies in the capital-exporting countries.

Finally, a large part of the foreign investments were in the field of costly basic public service facilities developed in advance of current needs—such as railways—and many took the form of portfolio investments in foreign government securities. The investments in this form were backed up, so to speak, by widespread adherence to the solid rules of the gold standard.

Contrary to many still-prevalent preconceived notions, including Marxian propaganda, foreign investments did not conquer pre-

existing markets in the new countries. Instead, markets were created there by European enterprise and personnel in the main. A lot more than mere capital was involved in the resulting growth.

In short, the nineteenth century investment experience was largely unique. It is doubtful, therefore, whether much of that experience is directly applicable to the contemporary underdeveloped world. But this is not to say that we have nothing to gain from a study of that experience. For instance, it suggests the need to expand public or public-utility type investment. It also indicates that American business firms are well situated to carry out direct business investments in underdeveloped areas, since these carry with them a considerable amount of technical know-how that is deficient locally. Again, it suggests the need to make considerable use of technical assistance as an aid to expanded private and public foreign investment, partly to assure that a maximum of domestic and foreign capital is channeled into the most productive forms of capital formation. It also suggests that a large role should be played by loans of the kind made by the World Bank. Finally, it indicates that there is a need to have more positive and affirmative policies in the underdeveloped areas to expand domestic savings and attract foreign capital.

#### **CAPITAL RECEIPTS AND INVESTMENT SERVICE**

The key to an understanding of the matter we are now to discuss is that borrowing countries should enjoy an import surplus if they are to receive development resources on a net basis. This is so, incidentally, for the same reason that, say, a young couple need to get command of more resources than they currently own if they are to finance the purchase of a house on a long-term mortgage basis. The couple, in short, must be able to go into debt; similarly, developing economies can achieve greater results if they supplement domestic resources by incurring long-term foreign debt, thus offsetting an import surplus.

An underdeveloped country obtains net foreign resources if it receives a given quantity of foreign capital on long-term account

and simultaneously pays out a smaller sum in servicing existing foreign capital within its borders—that is, if its receipts of long-term capital exceed its payments on interest, dividend, and gross capital-repayment account. The thing to be avoided, if possible, is net repayment of capital during the build-up stage. This may be achieved if the developing countries receive foreign capital at a rate in excess of the average interest rate payable on capital already within their borders. With suitable policies both in developing and lending countries, it should be possible to attain this desirable objective.

#### **SELF-SUSTAINED GROWTH**

An important question is whether developing countries will be able to look forward to a time when they can expand per capita income without further increments of net foreign capital. The answer may be seen more clearly if we think of investment, foreign or domestic, as essentially a process which provides resources for capital formation.

Initially, with low per capita incomes, underdeveloped countries are not able to have a high rate of voluntary savings. But they can step up their savings as income is increased. Thus, if underdeveloped countries are able to enjoy self-sustained growth when foreign capital ceases to enter on a net basis, they must experience a rise in the average rate of savings. This means that the marginal rate of savings, or the proportion of the additions to income from new investments which is saved, must be fairly high. If growth in per capita terms has gathered some momentum and there also are appropriate monetary and fiscal policies, developing countries can expect the marginal rate of savings to rise. Sometimes, in fact, it has risen by very respectable increments. As a rule, however, national plans for development assume a marginal rate of savings that is unrealistically high.

Of course, an authoritarian government does not need a rise in per capita output in order to achieve an increase in savings. But these are not voluntary savings. It can resort to the device of com-

pulsory belt-tightening, mainly by failing to produce the desired quantity and variety of consumer goods—as Soviet experience has clearly demonstrated.

#### THE PROBLEM OF REPAYMENT

Eventually, foreign capital has to be repaid in some form or facilities provided for repayment. To help see this problem in perspective, two points may be discussed. First, most direct business investments are made with the thought that, if successful, the investors will not repatriate their capital at an early date but instead will reinvest most of the earnings and in fact may continue to do so indefinitely. Second, loans have a maturity date and usually a regular schedule of amortization. But most international loans are made by governments or international lending institutions which can relend funds received from the servicing of old loans. That is, such lenders can pursue policies that avoid the need of early net repayment by developing countries and they can be expected to do so if the borrowing countries adhere to the rules of the game by following sound development investment and domestic policies and show a real respect for foreign capital and the positive role it can and does play in development. As output grows, a smaller proportion of national income needs to be devoted to imports. The savings in this department, as compared with an earlier situation, can be used to service foreign capital even if exports do not rise as fast as gross national product. In an economy with monetary stability and a flexible price system, adjustments can be counted on to facilitate repayment of that part of foreign investment which seeks repatriation.

The big question, however, is not whether the process may be a smooth one but whether the political and social climate is or will be appropriate in both lending and borrowing countries. Regarding the former, will trade policy facilitate imports and thus the servicing of foreign investments? With respect to the developing countries, will they wish to adopt long-term policies that are consistent with the requirements of steady foreign investment on the

part of capital-exporting countries? In this connection, it should be borne in mind that the nineteenth-century experience was one in which per capita incomes in debtor countries were never far below European levels. Today, interest payments by underdeveloped nations are mainly from the poor to the relatively rich, and many believe that such payments are contrary to the "spirit of the age." But (1) capital is not a costless article in the capital-exporting countries, and (2) countries cannot dishonor contracts and still expect to live in a smoothly functioning world community. Gifts in the form mainly of technical assistance, however, will provide resources to the poorer countries that are a partial offset to transfers of resources connected with the servicing of investments. Is it too much to expect that the underdeveloped countries will join with constructive forces to disregard false advice and phony ideology, domestic and foreign, and work to realize the immense benefits that accrue from long-term foreign investment and a sensible system of world trade?

### PROBLEMS

1. "It is by no means enough to equate good intentions in underdeveloped countries plus a liberal supply of dollars with sound economic development." *Explain.*

2. "That the Colombo Plan has barely kept pace with the birthrate does not imply that the countries of the area necessarily lack external finance." *Explain.*

3. "One thing must be said about world-power rivalry in this field: After years of inducing backward countries to put first things first in their economic development, America does not want to see Russian money financing the flashy project that will appeal more to the imagination of the crowd." *Explain.*

4. "Where there is a shortage of capital development can proceed at an attractive pace by concentrating on those sectors where knowledge can take the place of capital and human beings of machines." *Evaluate.*

5. "India's second five-year plan assumes that the nation will save one-quarter of the increase in income, against the present rate of about 7 per cent." *Explain.*

6. "Investment by American companies in manufacturing facilities abroad should get a boost from the IFC." *Explain.*



7. "The Food and Agricultural Organization has wisely accepted the view that there is usually no short-cut from primitive to modern methods of cultivation and livestock management, from crude instruments to power-driven equipment." *Explain.*

8. "Today the gap between the well-fed and the underfed in the world as a whole is considerably larger than when the FAO was founded." *Explain.*

9. "It is a common assumption, particularly in the United States, that the gift of material amenities to underdeveloped peoples would lessen their revolutionary inclinations and induce social tranquility. This is a fallacy." *Explain.*

10. "Money alone will not entirely solve the numerical shortage of experts who are able and willing to go out to South-East Asia." *Explain.*

11. "The World Bank has proved itself a model of international public enterprise." *Explain, and if possible illustrate by a recent example.*

12. "Underdeveloped countries are too poor to repay foreign loans; what they need are large grants for development administered by the United Nations rather than small grants arranged partly through a selfish and capitalistic government." *Evaluate.*

13. "American direct investments in merchandising, such as the foreign branches of Sears, Roebuck and Company, should be discouraged since the relatively simple activities in which they engage can easily be carried out by local capital in underdeveloped countries." *Evaluate.*

14. "One bird of increased local capital in the hand is worth two in a very unpromising foreign-aid bush." *Explain.*

15. "The politicians in some underdeveloped countries who advocate low salary ceilings forget that there is only a certain amount of silk purse material among the great mass of sows' ears." *Explain.*

16. "The disguised unemployment in the underdeveloped world is of such proportions that the United States in good conscience cannot reject appeals for large-scale development aid." *Evaluate.*





# **APPENDICES**



# The Pure Theory of International Equilibrium<sup>1</sup>

National economies, in the absence of severe government intervention, would normally adjust to one another through changes in national income and exchange rates. The earliest theories of the classical economists assumed gold movements at unchanging exchange rates and stressed the effect on domestic prices of changes in the domestic money stock occasioned by the balance of payments. Many subsequent economists, assuming a more or less constant domestic stock of inconvertible money, stressed the change in the local prices of imports and exports following a change in the exchange rate. Actually these two approaches, which might be thought of as the *money transfer* and *exchange-rate* approaches, can be unified with the help of income theory and what little has already been learned regarding the balance of payments. The resultant synthesis constitutes today's pure theory of international adjustment.

## CONDITIONS OF EQUILIBRIUM

One cannot discuss the manner in which one national economy adjusts to another without defining what one means by international equilibrium. Different concepts exist and are acceptable. In this appendix we assume that each national economy is in equilibrium if its exports minus imports equal its domestic saving minus domestic capital accumulation. The implicit assumption, the validity of which must soon be examined, is that any excess of domestic saving over domestic capital

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<sup>1</sup> This appendix is designed for economists who need to understand the interactions of national income, exchange rates, and the balance of payments; non-economists will probably not wish to pursue this matter so rigorously.

accumulation must somehow be loaned abroad; then the capital account exactly offsets the current account in each nation's balance of payments. Hence we say that a national economy will not be in equilibrium unless:

$$\text{Exports} - \text{Imports} = \text{Lending} = \text{Saving} - \text{Accumulation.}$$

A statement of this kind means nothing until the various terms are defined. Exports and imports mean all transactions occasioning current-account credits and debits respectively in the nation's balance of international payments. Saving refers to the excess of national income over total consumer spending by residents. Accumulation means the net increase in ownership by residents of real capital. Lending means net transfers of purchasing power between one national economy and another.

Lending, which here comprises all the capital accounts of the balance of payments, is partly a passive and partly an active element in the situation. Sometimes, because net merchandise trade is flowing in one direction, foreign-owned bank balances tend to accumulate in the buying country. Such an international transfer of purchasing power has been more of an effect than a cause. On the other hand, a decision to make international loans may occasion new trade flows, in which event this international transfer of purchasing power has been a cause rather than effect. Lending is not associated with national income or the exchange rate in quite so direct a manner as are exports and imports.

## NATIONAL INCOME AND THE FOREIGN BALANCE

### INJECTIONS AND LEAKAGES

A nation's imports and savings are related to the level of its national income, and the national income of a country is related to its rate of domestic investment and export sales. Domestic investment and export sales, for reasons soon to be explained, are often described as injections. Imports and savings, on the other hand, are sometimes described as leakages. We shall find that a national economy is in equilibrium when the sum of its imports and savings leakages is exactly offset by the sum of its investment and export injections.

Figure A.1 illustrates these various injections and leakages. All axes represent dollars. The vertical axis indicates national income ( $Y$ ) and is on a smaller scale than the others. The left-hand diagram, which employs a scale that reads from right to left, shows the value of export credits ( $E$ ) and import debits ( $I$ ) at each national income level. The

right-hand diagram, which uses a conventional left-to-right scale, gives the dollar value of domestic savings ( $S$ ) and domestic capital accumulations ( $A$ ) at each national income level.

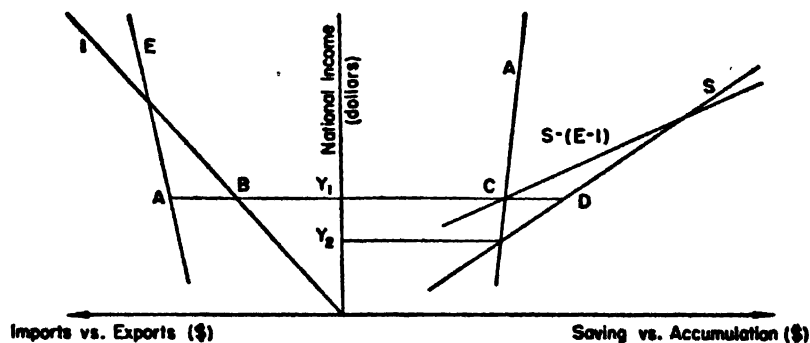


Figure A-1

The state of this nation's balance of payments can be seen in the left-hand diagram. Import debits ( $I$ ) rise when national income ( $Y$ ) rises, because households and firms then buy more of everything, including imported goods and services. However, the value of exports that foreigners would like to purchase ( $E$ ) is relatively unaffected by the level of income in this nation. Hence this country has an unfavorable balance of payments at high incomes and a favorable balance at low incomes. The state of the balance of payments is determined by the national income level.

#### NATIONAL INCOME DETERMINATION

What, however, determines the national income level? In order to answer this question we must review, if only cursorily, modern income theory. It is generally held today that, for a closed economy, national income depends upon the relation to income of intended saving and intended investment. As shown in the right-hand diagram, aggregate intended saving ( $S$ ), that is, the amount of factor earnings that households receive but do not spend on consumption, increases with national income. Also, aggregate intended capital accumulation ( $A$ ), that is, the sum of money that firms and governments invest in additional real capital, tends to rise with income, partly because there appear to be more numerous real investment opportunities when national income is high. However, intended real investment does not increase as rapidly as does intended saving when national income is increasing.



Now, if one considers these definitions of saving and capital accumulation carefully, it becomes obvious that no closed economy can actually accumulate any more or less than it actually saves. Hence, for a closed economy, national income must be such that intended saving and intended accumulations are equal. In the diagram this occurs at an income of  $Y_2$ .

The contrasting case of an open economy is also illustrated in the figure. The equilibrium national income is then  $Y_1$ . At this income level exports are  $AY_1$ , imports are  $BY_1$ , domestic saving is  $Y_1D$  and domestic accumulations are  $Y_1C$ . The *net* injection occasioned by foreign trade is exactly offset by the *net* leakage on the domestic front. Hence, for the entire system gross leakages equal gross injections, and this open national economy must be in equilibrium.

The resulting balance of trade (that is,  $E-I$  when measured horizontally from right to left) must be equal to what we have defined as lending. Hence, for graphic purposes, it can then be either added to the capital accumulation schedule ( $A$ ) or subtracted from the saving schedule ( $S$ ). (The latter alternative is the one illustrated in the figure and this is also evident from the intersection of the  $A$  schedule with the  $S-(E-I)$  schedule.) It is apparent that the economy will be in equilibrium when lending equals the favorable trade balance.

In a way, we can think of a national economy as resembling a separator like those used in the dairy industry. The stock of money within the economy will be analogous to the volume of whole milk within a separator. The level of income within the economy during a year will be analogous to the quantity of whole milk within the separator times the frequency of its revolutions per minute. National economies also experience injections and leakages just as do separators when in use. The two important leakages are the savings leakage and the import leakage; these are analogous to the cream and milk that come out of their respective spouts. The injections, analogous to pouring whole milk into the separator bowl on top, are purchases of exports by foreigners and domestic investment by local residents. In equilibrium, a separator should be losing cream and separated milk at the same rate as it is receiving whole milk, and a national economy should have savings and import leakages equal in value to the aggregate injection of domestic real accumulations and foreign export purchases.

By way of further explanation, let us consider the national income accounts of a given country. One set of accounts that would be consistent with the schedules of the diagram are those of Table A.1. In this case imports must have been worth \$20 billion. Apparently \$5 billion in domestic capital accumulation consisted of imported consumer

goods and \$15 billion in consumption was imported consumer goods. Aggregate savings—the excess of factor earnings over consumer spending—was \$35 billion, or \$10 billion in excess of domestic real investment. However, this excess was offset by lending foreigners \$10 billion to finance the net export balance.

\*  
TABLE A.1  
SOME ILLUSTRATIVE NATIONAL INCOME ACCOUNTS  
(in billions of dollars)

<i>National Product</i> (at factor cost)		<i>Disposition of Income</i> (or factor earnings)	
Exports	\$30	Lending to foreigners	\$10
Investment goods for home market (net)	20	Domestic real investment (inc. imported capital goods)	25
Consumption goods for home market (sold)	50	Domestic consumption (inc. imported consumer goods)	65
Total	\$100	Total	\$100

A word is in order regarding the ways in which *A*'s export balance may be financed. Residents of Nation *A*, a country that uses dollars, may buy dollar securities from foreigners; or they may buy foreigners' securities that are denominated in foreign currencies, in which case they must first acquire foreign exchange, perhaps by selling dollars. The actual lenders in *A* may be households, firms in the export trade, or government agencies, and they may buy short or long term debts. However, it is always possible within limits for *A*'s net export balance to be financed without recourse to any formal lending and borrowing between individuals. Foreign buyers of *A*'s goods may have formerly acquired dollar balances that they now draw down. Or residents of *A* may be willing to accept payment in foreign currencies that they accumulate as foreign bank balances. These ways of financing an active trade balance involve additions to or subtractions from the obligations of banks to depositors but they do not involve interest bearing debts. Essentially, both methods of financing exports involve the loan of purchasing power to one economy by another. For example, when *A* residents give up dollars to foreigners in exchange for bank balances abroad, and *A* residents hold these balances whereas foreigners use their dollars to purchase goods in *A*, there has been an economic loan of indefinite duration by *A* even though legally it may not seem so. Consequently, in this analysis, lending by one economy to another includes both formal borrowing and net changes in the international ownership of bank balances.<sup>7</sup>

Another important and related subject—which so far has not been faced squarely—is why exports are customarily viewed as an injection and imports as a leakage.

Exports can properly be considered an injection if it can be demonstrated that they lead to a disbursement of funds in excess of that which would otherwise have taken place. Actually, if we consider the case of a national income of  $Y_1$ , it can be shown that exports must normally lead to extra spending. If foreigners dishoard dollar balances there is an obvious and direct injection. If  $A$  residents exchange their dollar hoards for foreign bank balances that they do not spend, but foreigners buy exports with the dollars they so acquire, there has been a dishoarding of dollars attributable to exports. If  $A$  residents employ their savings to purchase the securities of foreigners, however these may be denominated, there is a direct or indirect dishoarding of dollars, provided these same saved funds would not otherwise have been invested at home.

A glance at the figure shows that, at the equilibrium income level of  $Y_1$ , such a purchase of foreign securities represents an additional rather than a substitute employment of savings. At  $Y_1$  income, firms, and governments in  $A$  are unwilling to invest more than  $Y_1C$  in real capital, whereas domestic households wish to save  $Y_1D$ . Hence, it is fortunate that there exists an additional opportunity to employ these savings through direct or indirect loans to foreigners.

Imports are a leakage, because imports are the opposite of exports, and because a leakage is the opposite of an injection. To the extent that  $A$  imports, foreigners do not have to finance their purchase of exports from  $A$  in the ways described above. The more  $A$  imports, the less foreigners need to sell securities to borrow, the less they need draw down their dollar balances, and the less they need to exchange bank balances in their own currencies for dollars. If imports equal exports in value there will be no net injection incident to financing exports. And if imports exceed exports, there will be a negative net injection of funds (a leakage).

#### **SOME EFFECTS OF CHANGING PROPENSITIES**

It is evident that any change in national income will alter the value of imports or exports and hence the balance of trade. More specifically, anything that has the effect of shifting one of the four basic schedules, shown in Figure A.1, will affect national income and the balance of trade. We must now consider what sort of developments might alter either the intended import schedule ( $I$ ), the domestic ac-

cumulation schedule (A), the domestic savings schedule (S), or the intended export schedule (E).

*Intended Import Schedule.* The import schedule would probably shift to the left (that is to say, Nation A would import more at each income level) if import restrictions, such as customs duties and quotas, were reduced and relaxed. If foreign firms introduce new kinds of products that quickly win international acceptance, the import schedule will also shift to the left. If certain domestic sources of supply become exhausted, the import schedule will again shift to the left.

Other things equal, an increase in the propensity to import, illustrated by a leftward shift in the *I* schedule of Figure A.1, will occasion additional leakages, reduce national income, and render the balance of trade either less favorable or more unfavorable. However, other things do not always remain equal or unchanged. For example, if import duties on all textile fibers and products were eliminated, the import schedule (*I*) would shift to the left; but so might the domestic accumulation schedule (*A*), in which case the unfavorable effects upon national income would be aggravated. On the other hand, a reduction in import duties might lead to households' spending more on consumption goods, and hence saving less at each income level. This is particularly likely to be the case where there are no close domestic substitutes for the foreign goods that can now be obtained more cheaply. In this case, the leftward shift in the import schedule may be matched by a leftward shift in the savings schedule, so that one leakage has simply been substituted for another, and national income may not fall.

So far, we have analyzed the effect of new developments upon the balance of trade. There is no reason why a larger framework of analysis might not be used, in which event we should consider the entire current account, and not simply the balance of trade. Imports and exports then represent all transactions that occasion current account debits and credits respectively.

### DOMESTIC ACCUMULATION SCHEDULE

Similarly, it does no real violence to our conclusions to suppose the domestic investment schedule to be a composite of private domestic accumulation and domestic government spending. Other things equal, an elimination of some type of government spending will shift the *A* schedule to the left, reduce national income, and worsen the current account. However, here again other things may not be equal. For example, the federal government might eliminate its subsidies to the

United States merchant marine, in which even more freight and passengers would be carried to and from American ports in foreign bottoms; hence both the *I* and the *A* schedules would shift to the left, and the unfavorable effect upon the current account and the national income would be aggravated. In fact, contemporary mercantilists claim that more stringent protectionist policies will tend to improve the balance of trade and increase national income, by simultaneously reducing import and raising investment propensities.

*Domestic Savings Schedule.* The savings schedule often seems more meaningful when it is thought of as being approximately equal to the sum of private saving and government taxes. Both private saving and government taxes are leakages; they can be analyzed either together or apart. If the tax laws are amended so that, at each income level, the government's tax receipts are augmented, the export balance and the national income should fall. However, there are complications when tax receipts, paid always in the currency of the levying government, rise or fall because of changes in the customs tariff. If a reduction in duty rates has the effect of reducing the value of customs collections, as it will tend to do when initial duty rates are low, the reduced tax leakage may offset the increased import leakage and national income may fall only slightly, if at all.

*Intended Export Schedule.* The intended export schedule (*E*) obviously depends in large part upon the level of national income in foreign countries. If the rest of the world is experiencing a fall in money incomes, countries abroad will tend to buy exports of less value from *A*, even though *A*'s national income may not yet have responded. In general, rising prosperity abroad will shift the *E* schedule of *A* to the left, and deepening depression abroad will shift it to the right.

The consequences of this fact are that prosperity or depression can spread from one country to another. If money incomes are falling in foreign countries, so that *A* sells exports of less value at each income level within *A*, this source of injections into the *A* economy will dwindle. A rightwards shift of the export credit schedule of the *A* economy will tend, in turn, to depress the level of national income within *A*. It is because of this international chain of money reactions that national incomes in different countries tend to rise and fall in sympathy with one another.

Now it is possible to explain in rough terms why *A*'s export credit schedule, as shown in Figure A.1, is not vertical but leans instead to the left. This signifies that foreign countries buy more of *A*'s goods and services when *A*'s national income is high, and now we can see why this is so. As national income rises in *A*, the export credit schedules of

*foreign nations* shift, so that they receive monetary injections. If *A* is importing goods of greater value, other countries must be selling goods of greater value. Consequently national income in foreign countries rises in sympathy with the rising national income in *A*. As a result, foreign nations buy more of *A*'s exports when *A*'s national income rises.

### THE EXCHANGE RATE AND NATIONAL INCOME

There are a number of different income levels, *given the rate of lending abroad*, at which equilibrium might be attained; but these different income levels involve different exchange rates, only one of which may be compatible. Similarly, there are a number of exchange rates, *given lending*, at which equilibrium might be attained; but these different exchange rates involve different income levels, only one of which may be compatible. Given the extent of international lending there is only one *combination* of income level and exchange rate that will be in a state of equilibrium.

Any possible interactions between the exchange rate (*X*) and the national income level (*Y*) must be attributable to existing relations between *X* or *Y* on the one hand and intended exports (*E*), intended imports (*I*), intended saving (*S*), and intended accumulation (*A*) on the other.

In the preceding section (see Fig. A.1) we supposed that *E*, *I*, *S*, and *A* were dependent to some extent on *Y*. However, the two leakages (*S* and *I*) were far more sensitive to changes in *Y* than were the two injections (*E* and *A*). The demand for exports is related to income rather indirectly by way of other countries. And the tendency for domestic businessmen to invest in more real capital as income rose is an indirect consequence of the tendency for households to spend some of their extra income on consumption. We shall probably not depart too far from reality if we hereafter assume that the two leakages, but not the two injections, vary with changes in national income.

Next we must make some assumptions regarding the dependence of *E*, *I*, *S*, and *A* on *X*. The effects of currency depreciation upon a nation's trade balance have already been discussed. Physically, the aggregate barter terms of trade worsen, so that a smaller quantity of imports is purchased and a larger quantity of exports is sold. The financial consequences of these physical changes are that import debits may fall and export credits will rise. (See Chapter 5.)

There is a question as to whether the exchange rate (*X*) affects domestic saving (*S*) and local capital accumulation (*A*). While any element can be linked to almost any other factor in economic theory,

with enough imagination, there is no obvious reason for expecting any effect on  $S$  of variations in  $X$ . There is also doubt regarding the interaction of  $X$  and  $A$ . Currency depreciation leads to more physical exports and fewer physical imports. This may cause increased real domestic investment during the transition phase; on the other hand, there may be a slackening in home production for home use. In view of these uncertainties it can be assumed that domestic capital accumulation is not affected by variations in the exchange rate. In short, as an approximate simplification, we shall suppose in the following analysis that:

Exports ( $E$ ) are dependent upon  $X$  but not upon  $Y$ ;

Imports ( $I$ ) are dependent upon  $X$  and  $Y$ ;

Savings ( $S$ ) are dependent upon  $Y$  but not  $X$ ;

Accumulations ( $A$ ) are independent of  $X$  and  $Y$ .

These assumptions are reflected in Figure A.2. The vertical axis of this diagram represents national income. The  $A$  and  $E$  schedules are

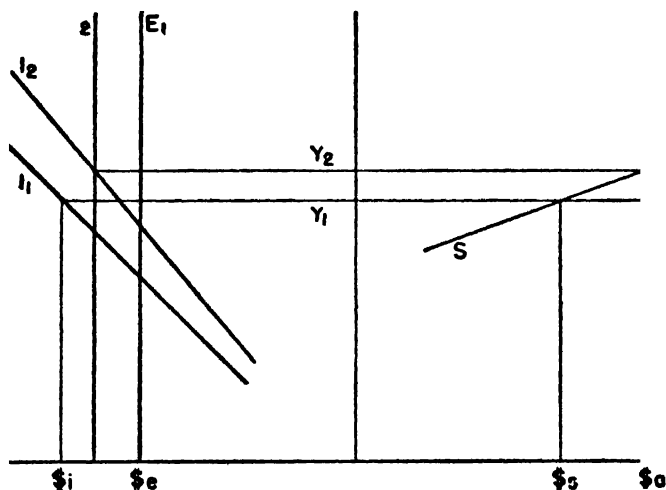


Figure A-2

both vertical, but the  $S$  and  $I$  schedules are sloped to show increases caused by increases in  $Y$ . Two schedules are shown for both  $E$  and  $I$ ; the subscript 2 refers to a later situation in which the currency has been depreciated.

Let us suppose that Figure A.2 illustrates the case of a rather tired national economy. The country is importing goods of greater value than it is exporting ( $\$i$  is to the left of  $\$e$ ). The country is not lending

( $\$e$  is to the left of  $\$a$ ), but is either borrowing from abroad or liquidating former foreign investments. Presumably  $\$e - \$i$  equals  $\$s - \$a$ . Here is an equilibrium situation dependent on the possibility of continued negative lending.

What will happen if these foreign assets become exhausted or no more funds can be borrowed from foreign investors and governments? For one thing,  $Y$  must rise sufficiently for  $\$s$  to come into equality with  $\$a$ . For another,  $X$  must depreciate sufficiently for  $\$e$  and  $\$i$  to come into equality, despite the fact that extra imports are induced by higher income. The outcome will be a depreciated currency ( $E_2$  to the left of  $E_1$ ), more employment and a higher money national income at home ( $Y_2$  rather than  $Y_1$ ), increased money saving, somewhat reduced import debits, and substantially increased export credits.

How much of the adjustment will tend to be achieved through exchange-rate variation and how much by national income change? If the propensity to save is very high (as shown by a rather flat  $S$  schedule), less strain will be thrown on either  $Y$  or  $X$ . If the propensity to import is very low (as shown by a very steep import debit schedule) there will be, compared to the national income change, a rather smaller change in the exchange rate.

A word of warning is in order here. The fact that national money income and employment have risen does not necessarily mean that the residents of this country are living better. The associated currency depreciation means that, at each income level, fewer physical imports are being received in exchange for more physical exports. The allocation of resources may be less satisfactory, even though the level of resource employment is higher, so that economic welfare may not be appreciably advanced. This national economy must now go to work and support itself.

### INCOMPATIBLE LENDING RATES

In an earlier section it was more or less implied that international capital transfers, called lending here, were induced by the level of national income. It appeared that the equilibrium national income was that which rendered the excess of saving over domestic accumulation just equal to the excess of export credits over import debits. This implied that the first excess ( $S-A$ ) was always converted into an international capital transfer sufficient to offset the other excess ( $E-I$ ). However, this happy arrangement does not always occur, and it certainly cannot be counted upon.

It takes two to make an international loan, even when no govern-



mental restrictions exist. Someone must be willing to accept the risks of lending, and someone else must be willing to incur the expense of borrowing. It often happens that those governments and firms that want to borrow are the ones to whom other firms and governments do not care to lend.

The circumstances that prompt firms in one country to lend to firms in another, and firms in the latter country to borrow from firms in the former, do not depend directly upon present exchange rates or income levels. If a foreign country depreciates its currency, it will become cheaper to buy assets there with other currencies, but the resultant income streams will then be lower when expressed in other currencies; hence, the rate of return, unless subsequent exchange-rate fluctuations occur, will not be affected. Higher income levels in a lending economy will increase the availability of funds for loan; however, whether they are loaned abroad will depend on circumstances that are normally unrelated to domestic income levels: by whether the borrowing economy has exchange controls, whether its government is socialistic, whether its budget is so unbalanced as to threaten currency depreciation, whether it is likely to become involved in war, and so on. The circumstances that prompt governments to lend or borrow funds are political rather than financial. A loan may be made to gain or arm an ally.

Since international capital transfers are increasingly carried on either by governments or under their auspices, and since opportunities for private capital transfers are severely limited by exchange-control schemes in most countries, it seems wise to treat lending as an autonomous rather than as an induced element in any analysis of exchange rates and national income. Before World War I, international capital may always have flowed from one country to another according to income levels and exchange rates, but this has not been happening since World War II.

If lending is *autonomous* rather than induced, it cannot be counted upon to equate surplus saving ( $S-A$ ) with surplus exports ( $E-I$ ). Governments, by fixing exchange rates, may render the difference between intended exports and intended imports unequal to the value of loanable funds available for international investment. Also, because of government fiscal policies, the value of loanable funds available for investment may not equal the difference between intended saving and intended domestic accumulation. Hence, lending may be incompatible with either exchange rates or national income, or both.

Figure A.3 illustrates a case in point. If international capital transfers were induced, rather than autonomous, there would be equilibrium with the combination of  $Y_1$  national income and the exchange rate

upon which  $E$  and  $I$  are predicated. However, for the reasons already discussed, lending may really be autonomous. It may be limited, by the willingness and ability of either borrowers or lenders, to the amount shown as  $L$  in the diagram. Hence, national income will really be at the lower  $Y_2$  level. At this income, and given the exchange rate, actual export credits will have to fall short of intended export credits by the amount  $BC$ .

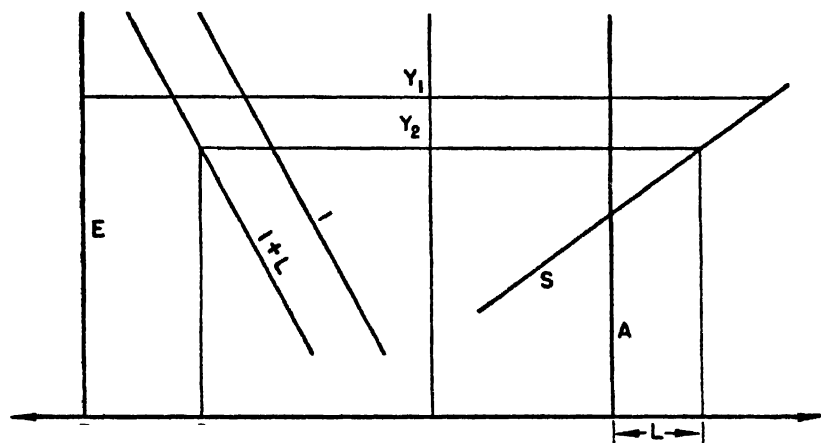


Figure A-3

Let us assume that the nation upon whose economy the diagram is based uses dollars. The  $E$  schedule shows the number of dollars that foreigners are willing to spend for that nation's exports. Of course, they must first obtain the dollars, either in loans from the potentially exporting country, or through that country's imports from them. We can suppose that they have long since spent any dollar bank balances they possessed, and have entered upon a constant dollar shortage.

This dollar shortage, given the income level, will be equal to intended exports minus the sum of lending and intended imports. In the diagram it is shown by the distance  $BC$  because  $C$  is equal to imports ( $I$ ) plus lending ( $L$ ) at this  $Y_2$  income level. Furthermore, the dollar shortage will continue as long as the rate of lending is incompatible with the exchange rate and national income combination.

The illustrated dollar shortage could be eliminated if any one of several developments occurred. An appreciation of the dollar would reduce intended exports credits and shift the  $E$  schedule to the right, while increasing import debits and shifting the  $I + L$  schedule to the

left. A relaxation of import restrictions would increase intended import debits at each income level and so reduce the dollar shortage. Expansionary fiscal policies, such as increased government spending and reduced tax rates, could shift the *A* schedule to the right, the *S* schedule to the left, and so raise national income and import debits. A more obvious but less fundamental recourse would be for dollars to be lent by the home government to foreign governments or firms. Or a publicity campaign might be launched to increase the willingness of domestic savers to loan abroad and of domestic buyers to purchase imports. If the dollar remains scarce in the world it is not for lack of remedies.

## CONCLUSIONS

There is always some national income, given the exchange rate, which will maintain a national economy in equilibrium if international capital transfers are induced and unrestricted. On the other hand, if lending from one economy to another is autonomous, there is probably some exchange rate that will maintain the economy in equilibrium for a given income level. If the intended schedules of saving and accumulation are known, it is possible to find some combination of exchange rate and national income that will maintain equilibrium for a given value of autonomous lending.

A national economy will be in equilibrium when its export injection minus its import leakage is equal to lending, and when lending is equal to its saving leakage minus its accumulation injection. The extent of surplus exports or surplus saving at any given income level is determined by the position and slope of the schedules of intended exports, imports, saving, and accumulation. These can all be influenced by government policy. The intended export and intended import curves depend upon the exchange rate. And the intended saving and intended accumulation schedules depend upon government spending and taxing policies.

Hence, fiscal policy and exchange-rate policy are closely related. Starting from an equilibrium without lending, expansionary fiscal policies, by raising national income, may compel currency depreciation unless foreign funds are available. Alternatively, again starting from an equilibrium without lending, currency depreciation will either instigate a capital outflow or compel the home government to adopt expansionary fiscal policies. Or, of course, governments can follow incompatible exchange rate and fiscal policies, and thereby keep the home economy in some state of controlled disequilibrium.

## APPENDIX B

# Mercantile and Classical Theories of International Trade

The new geographical discoveries that ushered in the sixteenth century expanded the foreign trade of western Europe. It was inevitable that merchants, statesmen, and philosophers in the affected countries should turn their attention to the behavior of money, prices, and markets. Certain of these men came to the conclusion that an export trade balance would make a state powerful and prosperous. These mercantilist views obtained general acceptance in intellectual circles until shortly before the close of the eighteenth century, but by then maturer reflection had occasioned misgivings and doubts. Adam Smith administered the *coup de grâce* to mercantilism. The resultant void did not long remain empty, for the beginning of the nineteenth century witnessed the evolution of what was later to be known as the *classical theory* of international trade. The new theory tended to be deductive and theoretical, especially at the outset, and emphasized real forces, such as labor and commodities, to the neglect of money and prices. These principles were elaborated during the remainder of the nineteenth century and have only recently been superseded. The doctrines of the mercantilist and classical writers bulk so large in the development of economic thought that, despite a diminished usefulness, professional students of economics can hardly afford to remain ignorant of them. Accordingly this appendix is included.

### MERCANTILIST VIEWS

A majority of the political economists who wrote during the seventeenth and early eighteenth centuries emphasized the desirability of exports overbalancing imports, and unanimously recommended various state regulations to accomplish this objective. These men are known as *mercantilists*; or occasionally, in the case of the earliest writers, as *bullionists*.

The English, unlike the Spanish, possessed no gold or silver mines in the New World. They could obtain specie, bullion, or treasure only through the acquisition of new possessions containing mines, by pirating on the high seas, or by foreign trade. The second method was characteristically Elizabethan. But of course it was foreign trade that gave the most promise of continued success in the long run.

Pamphlet writers, men of public affairs, and others having leisure and inclination to concern themselves with the subject, expressed the rather obvious idea that gold and silver would be introduced into the kingdom if goods of greater value were sold abroad than were bought from foreigners. The following comments of Sir Francis Bacon, written in 1616, are so typical that a single example will suffice.

This realm is much enriched, of late years, by the trade of merchandise which the English drive in foreign parts; and, if it be wisely managed, it must very much increase the wealth thereof; care being taken, that the exportation exceed in value the importation; for then the balance of trade must of necessity be returned in coin or bullion.<sup>1</sup>

These ideas are all too prevalent even today.

No one will quarrel with the mercantilist assertion that an export balance will introduce gold and silver into the nation. At that period the balance of payments consisted almost entirely of trade items. Loans were very infrequent and were mostly limited to borrowings by princes from rich goldsmiths and silversmiths. Consequently, redemption and interest payments hardly entered into international accounts. The only invisible items of any consequence were shipping service, Catholic remittances to Rome, and later, rent payments from Ireland to absentee landlords. The real issue between the mercantilists and latter-day economists concerns the desirability of a gold and silver inflow.

Modern economists consider it axiomatic that money is primarily a means to an end. Men labor after money not for itself, but in order

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<sup>1</sup> *The Works of Francis Bacon*, Edited by Basil Montagu, Vol. 2 (Philadelphia: 1852), page 385.

to command goods in consumption. Also, being a highly convenient medium of exchange, money facilitates specialization of production, and hence increases economic efficiency. However, a great many mercantilists felt that the mere existence of gold and silver within a country, even though it were withheld in private hoards or in the state treasury, contributed to the well-being of the people and state. What is the explanation of this attitude?

A number of royal advisors were probably obsessed with the importance of keeping a war chest. The financing of the recurrent national and dynastic struggles was always a problem. Tax systems were very rudimentary, and customs were still the principal source of revenue apart from the royal estates. The armies and navies were paid partly from the monarch's own pocket or out of individual subscriptions. Most of the ships which routed the Spanish Armada were owned by private associations of gentlemen and adventurers. Charles I created a storm of resentment when he imposed a ship-money tax on the larger towns in order to strengthen the Royal Navy. Success in war frequently went to the prince who could afford the largest army of mercenaries and the biggest navy. Responsible statesmen knew that money, which in those times meant gold and silver, was rightly described as the *sinews of war*. Consequently, the military power and diplomatic influence of a state rested in no small measure on the size of its war chest and the amount of gold and silver that was in circulation within its jurisdiction.

There was probably also a moral basis for some of the lauding of exports over imports. The foreign traders in the cities tended to be puritanical and to eulogize thrift and frugality. Accumulation of gold and silver by the nation as a whole was considered a virtue. Moreover, many of the imports into England, such as wines, brandies, spices, jewelry, and exotic animals were luxuries intended for the courtiers and gentry, and were of a character offensive to God-fearing people.

A very few of the best mercantilistic thinkers viewed money receipts as a stimulus to the national economy. The centuries in which they lived were marked by a growth of trade and population. This, plus an increasing division of labor, meant that more money was needed to facilitate trade and to prevent the depressing effect of falling prices. There was a money famine which, in the days when negotiable credit instruments and paper money were largely unknown, could only be alleviated by an influx of the precious metals. It is noteworthy that these old ideas have recently been revived and widely acclaimed by professional economists.

However, the simplest, least flattering, and most probable explanation of why the majority of mercantilists thought as they did is that

they were generalizing from their individual experience and interests. If a man with a great deal of money lives more comfortably than others, why should this not be true of a nation? If sensible men save against a rainy day, why should this not be a wise policy for a whole people? If money brings power to a family, why not to a state? Moreover, it should never be forgotten that the mercantilists often viewed public affairs with a class bias. Many of them were wealthy tradespeople who wanted to sell easily and for a good price at home and abroad. Accordingly, they welcomed any action by the state that would protect them from foreign competition or would develop markets overseas. Mercantilists were almost always employers and usually thought that low wages would promote the national interest by encouraging exports. It is but human to assume that policies favorable to one's own welfare will also be beneficial to all, and to suppose that one is under a social obligation to urge such policies on the public at large.

The mercantilists are important because they influenced the thinking of later economists in one way or another. A few of their observations were later synthesized by Hume. Mercantilist doctrines became the target of Adam Smith's barbed criticism; and their theories stand as a contrasting background behind the principles of the classical writers who followed.

Mercantilist doctrines are fascinating to those who are interested in the workings of the human mind. These doctrines have a universal appeal. Their essential assertions conform to everyday experience and to what passes for common sense. They have a self-evident quality; indeed, their truth is as obvious as the flatness of the world. Ordinary men in every time and clime will think mercantilist thoughts quite readily and without the effort of deliberate reasoning. Mercantilism is a tenacious attitude that economic science must root out from each succeeding generation.

### DAVID HUME AND THE INTERNATIONAL DISTRIBUTION OF SPECIE AND BULLION

In his *Political Discourses* published in 1752, David Hume combined a number of earlier theories to prove the utter futility of all state schemes to accumulate gold and silver within a nation. None of the elements of Hume's *tour de force* was novel, but he united these elements more effectively than any previous writer. And his reputation in other fields ensured widespread notice of his economic theories.

Hume began with the quantity theory of money which had been

evolved by John Locke almost 50 years before and which asserts that prices vary directly with the amount of money and inversely with the supply of goods. Hume was also familiar with the concept of specie or gold points acting as checks on fluctuations in money-exchange rates, a principle that had already been enunciated by Samuel Clement at the end of the seventeenth century. An earlier writer named Dudley North had previously pointed out that bullion tended to be minted when money is scarce and that coins are usually melted down when prices are low. Hume was able to synthesize these related notions into a description of the now familiar price-specie-flow mechanism of adjustment. The following passages are deservedly famous:

. . . Suppose that all the money of Great Britain were multiplied fivefold in a night . . . Must not [the price of] all labour and commodities rise to such an exorbitant height, that no neighbouring nations could afford to buy from us; while their commodities, on the other hand, become comparatively so cheap, that, in spite of all the laws which could be formed, they would be run in upon us, and our money flow out; till we fall to a level with foreigners, and lose that great superiority of riches, which had laid us under such disadvantages?

Now, it is evident, that these same causes, which would correct these exorbitant inequalities, were they to happen miraculously, must prevent their happening in the common course of nature, and must forever, in all neighbouring nations, preserve money nearly proportional to the art and industry of each nation. (pages 325, 326)

The political significance of such doctrines was very great. The *raison d'être* of most mercantilistic restrictions on foreign trade was an augmentation of the nation's gold and silver holdings. If, as Hume wrote, the magnitude of these accumulations was determined under natural law, why not permit overseas commerce to proceed untrammelled?

### ADAM SMITH'S ARGUMENTS FOR FREER TRADE

*The Wealth of Nations* was published in 1776. Only a few of its many chapters relate directly to foreign trade, and yet this single book did more than any other to introduce free trade into western Europe. Adam Smith was primarily a philosophic observer of man's struggles to win a livelihood from his surroundings. He was interested in commercial operations because they were a means to that end. He engaged in economic theorizing only when he could quickly arrive at a working conclusion. It is unlikely, had he been a mathematically inclined economist



of the modern type, that he would have been able to count so many leading statesmen among his avid readers.

Division of labor and its attendant advantages are the dominant theme in Smith's scheme of principles. He was greatly impressed by the extra output a community can make if each household specializes in production. Concentration on one line of endeavor permits the individual to increase his knowledge, skill, and efficiency. He can then afford to augment his output by employing specially adapted tools. Enforced self-sufficiency, by way of contrast, condemns families to a miserable scratching of the soil and the lowest subsistence endurable.

These ideas were not entirely novel even in Smith's day. His real contribution lay in attacking the numerous guild and government restrictions on trade. He hated such obstructions because they prevented a more complete division of labor. After all, productive specialization is only possible if one can exchange surplus output for the things one has not made oneself; otherwise, everybody must squander his energies in undertaking a great variety of projects, and suffer accordingly. Smith held that these were universal truths and as applicable to foreign as to domestic trade. Consequently, he looked upon customs duties as contrary to the social interest, and was inclined to regard the smuggler as a public benefactor. Smith had a vitriolic pen, and he was at his best when ridiculing mercantilistic theories or chastising the greed of monopolizing businessmen. These verbal attacks were to take effect in the decades to come.

The following quotations exemplify the way in which Smith sought to convince his readers that every nation should produce those things for which it was best suited.

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a tailor. . . .

What is prudence in the conduct of every private family, can scarce be folly in that of a great nation. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. . . .

. . . By means of glasses, hotbeds, and hotwalls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines, merely to encourage the making of claret and burgundy in Scotland? (pages 424, 425)

Smith's wrath was readily aroused by the doctrine that there should be a bilateral balance of trade between each pair of nations. On this score he could become quite rude:

The Portuguese, it is said, indeed, are better customers for our manufacturers than the French, and [their imports] should therefore be encouraged in preference to them. As they give us their custom, it is pretended, we should should give them ours. The sneaking arts of underlying tradesmen are thus erected into political maxims for the conduct of a great empire; for it is the most underlying tradesmen only who make it a rule to employ chiefly their own customers.

. . . That it was the spirit of monopoly which originally both invented and propagated this doctrine, cannot be doubted; and they who first taught it were by no means such fools as they who believed it. In every country it always is and must be the interest of the great body of people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. (pages 460, 461)

Smith was sufficiently ahead of a majority of his contemporaries to deny that an export balance was necessarily a favorable balance of trade. Instead, he emphasized what he termed the *balance of annual produce and consumption* which gauges capital accumulation and additions to a nation's capacity to make goods. The following paragraph possesses both economic and historic interest.

The balance of produce and consumption may be constantly in favor of a nation, though what is called the balance of trade is generally against it. A nation may import to a greater value than it exports for half a century or more, perhaps, together; the gold and silver which comes into it during all this time may be all immediately sent out of it; its circulating coin may gradually decay, different sorts of paper money being substituted in its place, and even the debts too which it contracts in the principal nations with whom it deals, may be gradually increasing; and yet its real wealth, the exchangeable value of the annual produce of its lands and labour, may, during the same period, have been increasing in a much greater proportion. The state of our North American colonies, and of the trade which they carried on with Great Britain, before the commencement of the present disturbances, may serve as proof that this is by no means an impossible supposition. (pages 464, 465)

In later years Smith was to become a rallying point for those business interests in Britain and western Europe who desired an extension of free trade. The merits of his book have invested it with tremendous influence, ever since its publication. The primary importance of book and

author, at least as far as the field of international economics is concerned, lies in the demonstrated power of their enlightened propaganda.

### DAVID RICARDO AND THE PRINCIPLE OF COMPARATIVE ADVANTAGE

David Ricardo's *Principles of Political Economy and Taxation* was first published in 1817. It immediately commanded attention because its author's reputation had already been established by his earlier pamphlets and essays, by his financial success on the Stock Exchange, and possibly by his membership in Parliament. This book is a thorough theoretical treatment of the whole subject of domestic value and distribution. Only Chapter 7, "On Foreign Trade," is of immediate concern to us.

Ricardo's major contribution to the theory of international trade was an idea later to be dignified in text books as *the principle of comparative cost*. He was anxious to show that a nation might properly import goods that it could itself make with a lower expenditure of labor as long as its relative efficiency in making other exportable goods was even greater. In order to make this point Ricardo supposed that Portugal sent wine to England in exchange for cloth, and that the labor cost of production of these goods in the two countries was as follows:

#### COMPARISON OF LABOR COSTS

	<i>Portugal</i>	<i>England</i>
Wine (x bl)	80 men a year	120 men a year
Cloth (y yd)	90 " " "	100 " " "
(x bl of wine trade evenly for y yd of cloth)		

Evidently Portugal can make both commodities more economically in terms of labor expenditure than can England. Notwithstanding, Portugal should specialize in wine and import cloth. She can then obtain cloth for only 80 man-years of labor by exporting wine for imports of cloth. This is a saving of 10 man-years because it would cost her 90 man-years to produce the cloth domestically. This pattern of foreign trade, by economizing on the use of Portuguese labor, should permit a greater total production and consumption in Portugal.

England is likewise benefited by this trade. Through international exchange she is able to obtain wine in return for 100 man-years of work in making cloth. If this wine were made in England, it would require the work of 20 extra men a year.

Ricardo described resultant wastes through self-sufficiency thusly:

If Portugal had no commercial connection with other countries, instead of employing a great part of her capital and industry in the production of wiles, with which she purchases for her own use the cloth and hardware of other countries, she would be obliged to devote a part of that capital to the manufacture of those commodities, which she would thus obtain probably inferior in quality as well as quantity. (page 82)

The important principle here is that a nation should not produce all the goods it can make *cheaper* but only those it can make *cheapest*. Or in the case of a singularly inefficient country, it should not cease all production simply because its labor costs are *more expensive* in every trade; it should rather drop only those lines in which its performance is *most expensive*. In the above example the Portuguese costs were only 66 per cent of the English in making wine, but 90 per cent in cloth making, and so Portugal specialized in the commodity that she could make with the greatest relative efficiency. And England concentrated on the goods that she could produce with the least relative inefficiency.

What would transpire, however, if by some strange coincidence, one nation might be able to make all goods with only 80 per cent of the labor expenditure required in some other country? There would then be no trade between these two territories because the first country would not enjoy a *comparative* cost advantage in any single line.

Ricardo's was not a complete theory of international trade. It did not attempt to explain what determines the amount of wine that is traded for some quantity of cloth, but simply made an assumption to help explain comparative cost. Ricardo was also unconcerned about the broader equilibriums which take place when two national economies adjust to one another through foreign trade.

Economists of the English classical school, of which Ricardo was one of the original and outstanding members, possessed several common characteristics. One of them was a labor theory of domestic value. The classical economists united in their assertion that the prices of goods within a country were proportional to the relative quantities of labor needed to make them. However, they held that this theory was inapplicable in the case of international price relations because labor and capital were immobile among different countries. At this point, when they passed from the domestic to the international sphere, their cost approach to price determination proved inadequate. However, the classical school, by phrasing their analyses in real terms and abstracting prices, could often relate these analyses more directly to problems of economic well-being. This was at once their weakness and their strength.

## JOHN STUART MILL AND THE EQUATION OF INTERNATIONAL DEMAND

John Stuart Mill, writing 30-odd years after Ricardo, also addressed himself to the question of how international values, as contrasted with domestic values, are determined. Two chapters of his *Principles of Political Economy*, published in 1848, explain how the *barter terms of trade* between two countries are established by the *equation of international demand*, which is sometimes called the *principle of reciprocal demand*. Mill thus sought to fill one of the most serious gaps in Ricardo's doctrines.

The barter terms of trade refer to the amount of an imported good that trades evenly for some amount of an exported good. In other words if the aggregate value of each of the two goods is equal to that of the other, the barter terms of trade are simply the reciprocal of the price relation.

A country's barter terms of trade are said to be improved if the price received for each unit of export becomes higher relative to the price paid for each unit of import. This means that a larger quantity of imports is received for the same quantity of exports, or perhaps that the same imports can be had for fewer exports.

Mill commenced his investigation by assuming a situation in which England exported broadcloth to Germany in exchange for linen. His example ran in terms of comparative *advantage*—that is, the differential outputs obtained from an equivalent input of labor—instead of in terms of comparative *cost*. Specifically, Mill assumed the following outputs from a given expenditure of labor:

	<i>Germany</i>	<i>England</i>
Linen . . . . .	20 yd	15 yd
Broadcloth . . . . .	10 yd	10 yd

He then asked himself what would be the outside limits to the barter terms of trade if England specialized in broadcloth and Germany exploited her comparative advantage in linen. The answer is that no nation will accept less favorable terms of trade than the output relationship that would prevail at home if *both* commodities were produced domestically. If England were an isolated economy, one yard of broadcloth would exchange within the country for one and one-half yards of linen; accordingly, England will engage in international trade whenever she can obtain equal or more favorable terms. For similar reasons Ger-

many will be willing to give up two yards of linen, or less if possible, for a yard of broadcloth. The linen to broadcloth terms of trade must lie somewhere between 2 to 1 and 1.5 to 1 if there is to be any international trade.

Mill asserted that the actual terms of trade will be governed by the necessity of having the total value of the exchanged cloth and linen equal to each other. His analysis did not run in *money* prices but rather in *linen* prices of cloth. Now, should the linen price of cloth rise, the English will offer less cloth per yard of linen, and the Germans will offer more linen per yard of cloth. However, there will only be equilibrium when the ratio of the linen yardage offered to the supply of cloth yardage is equal to the linen price of cloth. In semi-algebraic form this would require that

$$\frac{\text{linen offers}}{\text{cloth offers}} = \text{price of cloth expressed in linen}$$

or

$$\frac{\text{cloth offers}}{\text{linen offers}} = \text{price of linen expressed in cloth.}$$

If this condition is fulfilled, the total value of the goods traded will be equal whether calculated in terms of linen or cloth. Mill believed that there would be only one linen price of cloth that would equate the linen value of the cloth offerings and the linen yardage supplied.

Mill also wanted to know what determined the share each country received of the total potential gains from trade. For example, if the equilibrium value of 10 yards of cloth is 17 yards of linen, England gains two yards, and Germany saves three yards by engaging in trade. At a higher linen price for cloth Germany would save less and England would gain more. This development might take place if the demand for cloth increased or the need for linen fell.

Mill was also concerned with what he termed the *extensibility* of foreign demand. For example, what will happen if technical improvements in Germany, which are not possible in England, enable the same quantity of German labor to produce 30 yards of linen as previously could make only 20 yards? If 10 yards of cloth previously exchanged for 17 yards of linen, one might suppose that they will now exchange for half as much more, or 25½ yards of linen. But this will depend upon the new English demand for linen at its cheapened price. If the extensibility is one, the proportionate increase in the quantity of linen bought by England will be equal to the proportionate reduction in the price of linen defined in terms of cloth. The final equilibrium trade terms will then in fact be 25½ yards of linen to 10 yards of cloth, and England will

share the benefits of the new techniques equally with Germany. However, if the extensibility of English demand is more than one, so that the reduced cost of linen results in the English offering more cloth than before, then the final terms of trade will be less than  $25\frac{1}{2}$  yards of linen to 10 of cloth; and although both countries will be better off than before, the Germans will benefit more because they can now get a larger amount of cloth for the same labor expenditure in exported linen. Finally, if the extensibility of English demand is less than one, the equilibrium trade terms will be more than  $25\frac{1}{2}$  to 10, and although the English benefit by more than the improvement in German linen manufacture, the Germans must make a greater labor expenditure in linen if they are to enjoy cloth imports. It is noteworthy that Mill's *extensibility* is perfectly analogous to Marshall's *elasticity* except that in the former instance price is expressed in commodity units and in the latter case in money.

The importance which Mill attributed to degree and extensibility of international demands is indicated in the following passage:

The only general law, then, which can be laid down is this. The values at which a country exchanges its produce with foreign countries depend . . . on the amount and extensibility of their demand for its commodities, compared with its demand for theirs. . . . The more the foreign demand for its commodities exceeds its demands for foreign commodities, . . . the more favorable to it will be the terms of interchange: that is, the more it will obtain of foreign commodities in return for a given quantity of its own. (page 603)

Mill also took cognizance of the fact that some countries, having great difficulty in diverting resources from domestic to export trade, will probably obtain better terms when an increased foreign demand leads them to augment their exports. However, this fleeting reference to supply determinants is incidental to his theory as a whole; it is only mentioned, in his own words, "for the sake of scientific correctness." He was convinced that it "does not seem to make any very material difference in the practical result."

Despite the primitive methods he had to employ, Mill added very greatly to the rather rudimentary ideas of Ricardo. His long pages of involved English would today be translated into a simple diagram containing two offer curves—the offers of cloth for linen by England and of linen for cloth by Germany. He abstracted money from his analysis and hence tended to neglect the many problems of financial equilibrium and price relationships which are an essential part of international trade theory.

### NASSAU SENIOR AND INTERNATIONAL WAGE COMPARISONS

An important link between two highly significant variables was established by Nassau Senior when he wrote *On the Cost of Obtaining Money* in 1830. One of the matters he discussed was the relationship among the wage levels of different countries, and in considering this matter, he made assumptions common to the classical school of his day.

Senior clearly sensed that though labor might be immobile among nations, its productivity and wages are interrelated through the common prices of internationally traded goods. The labor force in each country is in effect competing indirectly with the labor force in every other country with which trade is carried on. This follows from the fact that a nation will not produce a good unless the comparative efficiency of its own as against foreign labor, ignoring obstructions to trade, outweighs the wage-level relationship between the two countries. Thus, if Britain and India exchange goods, and a Briton is eight times more productive at some trades than a Hindu, the wages of the Hindu cannot be more than one-eighth as large. The labor-productivity ratio must be commensurate with the wage level ratio.

Senior was also interested in international price comparisons of goods not entering into world trade. He noted that the mobility of labor within a country compelled producers to pay the same wages in domestic industry as are paid in the export trades. His final conclusion was that prices of domestic and untraded goods would be low (as compared with abroad) if labor productivity in these trades, relative to the nation's export industries, was high (again as compared with abroad). However, these goods might yet fail to be exported because of freight costs or import duties.

### THE REFORMULATED CLASSICAL THEORY OF INTERNATIONAL TRADE

The balance of the nineteenth century brought many additions and refinements to adorn the earliest ideas of Ricardo and Mill. Cairnes, Nicholson, and Bastable helped in the work of reformulation. Marshall, and recently Taussig, attempted more drastic restatements. Today there is less unanimity of treatment and greater variation in complexity than existed almost a hundred years ago. However, the classical theory of



international trade, as reformulated by Taussig and others in the twentieth century, possesses a basic framework which can be presented quite succinctly.

It will save time if we enumerate the major assumptions and simplifications at the outset. (1) Labor and all other productive factors are mobile within a country and immobile among nations. (2) Domestic price relationships are based on the cost of the 'labor embodied in a unit of each commodity. (3) Competition within each country prevents all save necessary profits. (4) Domestic commodity and factor prices are a function of the money supply. (5) Increased supplies of a commodity at any given time can always be produced at the same unit cost as before. (6) There are no cost obstructions to the transfer of goods among countries. (7) The balance of payments consists only of trade items. (8) Countries are on an automatic gold standard. The sixth and seventh assumptions are mere simplifications and could be dispensed with if necessary, but the eighth cannot be relaxed without distorting the framework out of recognition.

Certain theorems can now be deduced from a comparison of two countries.

First, Country X will rely entirely on imports of Good A if the price charged by producers of A in X is higher than that charged by producers of A in Y. This follows from supposition 6.

Second, the price charged for A in X is equal to the per-unit costs of producers of A in X. This follows from supposition 3.

Third, the per-unit costs of producing Good A in X are based on the wage paid each worker in X, divided by the productivity of each worker in X. This is based on supposition 2. Some classical writers have asserted that per-unit costs are not necessarily *equal* to wage expense per unit of output, but need only be in some fixed *proportion*.

Fourth, if Good A is exported from X to Y, then the ratio of wages to labor productivity in the making of A in X, the unit total costs for A in X, and the price of A in X, must all be lower in X than correspondingly in Y. This follows from the three preceding theorems and from assumption 2.

Fifth, if X has an export balance with Y, the quantity of money in X will be increasing while it will be decreasing in Y. This follows from suppositions 7 and 8.

Sixth, an increasing quantity of money in X will raise wage rates, per-unit costs, and commodity prices in that country. Converse developments will occur in Y. This follows from supposition 4.

Seventh, higher prices in X and lower ones in Y will result in X exporting a smaller variety of goods to Y, and a reduced volume of

those commodities which are still exportable. In this way equilibrium will be restored because the net receipts of *X* will decline.

Eighth, a country with an export balance, and which is receiving money, is commanding less favorable terms of trade than it could. It could exact more imports per unit of exports or pay fewer goods for imports.

Ninth, countries with the most productive labor can support the highest wage levels. Provided that conditions are in equilibrium, high wages evidence high productivity. They are a sign of competitive strength.

Various implications of this theoretical scheme may become more obvious if we study the answers the scheme provides to three important questions.

(1) How do we know what goods will be traded? A country will export those goods that she can produce with comparatively lower *real* costs, or which is the same thing, with absolutely lower *money* costs. In the case considered immediately above, Country *X* had a lower money cost in the production of Good *A* than did Country *Y*. However, these lower production costs are attributable to the fact that the *X* labor employed in making *A* is abnormally productive.

The *average* productivity of labor in *X* as compared with labor in *Y* is shown by the relationship of the wage levels in the two countries. Labor is twice as productive in *X* if we assume wages there are double those in *Y*. Therefore, if *X* is to have lower money costs of production for *A*, the efficiency of its labor employed in *A* must, other things equal, be above average for *X*, or more than twice as productive as *Y* labor making *A*. Alternatively, other things equal, *Y* labor employed in making *A* must be even less productive than usual. In either event the fact that *X* has lower money costs in making *A* reflects the fact that the quantity of labor required to make *A* in *X* is not merely less than that needed in *Y*, but that this disparity is wider than normal. This is equivalent to saying that *X* has comparatively lower real costs than *Y* in the making of *A*.

The fundamental identity of comparatively lower real costs and absolutely lower money costs would be apparent in domestic trade. Then the mobility of labor would ensure a uniform wage rate. A producer could have lower money costs than his rivals only if it took his laborers fewer man-hours to produce a unit of output than it took his rivals' workers.

(2) How is equilibrium in international payments restored? A country that possesses an export balance will receive gold, and this will expand the domestic money supply. Wages, unit costs, and commodity

prices will, rise in accordance with the quantity theory of money. Consequently, assuming the general demand for exports is elastic, national credits will fall, and debits will rise. Opposite events will be taking place in the country that previously had a related import balance.

(3) How are the terms of trade determined? It is still essentially true, to quote Bastable's paraphrase of Mill, that

The ratio of exchange, in the case of commodities which are the subject of international trade, depends on the comparative intensity of demand on each side, always, of course, operating within the limits set by comparative cost. (page 27)

However, this does not mean that the costs of producing a commodity are entirely without influence on the terms of trade.

Put very baldly, the price of a specific good is directly determined by its costs of production, but the general level of money costs within a country is indirectly based on the comparative intensity of foreign demand. Let us consider the immediate supply side first. Assuming competition and constant cost, the per-unit cost of production will always be the same, and will equal the supply price; and if the supply schedule is a horizontal line, unit production costs must then equal the equilibrium price in the market. Accordingly, the prices of exports, and consequently part of the barter terms of trade, are based directly on costs of production. Here we can shift our attention to the indirect influence of foreign demand. The general level of money costs (the prices of labor, materials, and so on) is dependent upon the workings of the quantity principle of money. A country that can attract and hold a great deal of money will have high factor prices. The ability of a country to maintain a large money stock is partly due to its economic efficiency—that is, the productivity of its labor—but it is also due to the extent to which other countries want its goods. A strong foreign demand means large sales abroad; this volume of exports brings money into the country, which in turn raises costs, and hence prices, until equilibrium is established.

It is important to note that the nations that benefit most from international trade are those that can attract and hold the largest relative stock of money. This gives them higher costs and prices, and consequently improved barter terms of trade, but their initial ability to secure an export balance and gain money depends upon superior efficiency. The productivity of their labor must more than offset their higher wage rates. Superior labor productivity may be due to human excellence, wise and stable government, efficient equipment, or a rich endowment of natural resources.

## • CRITICISMS OF THE CLASSICAL THEORIES

It is simple enough to discredit the classical theories, although the logic itself is impeccable, because some of the vital assumptions detailed at the beginning of the preceding section are wholly unrealistic.

It is untrue that there is complete mobility of productive factors within a country and immobility among nations. Cairnes pointed this out when he emphasized the existence of noncompeting labor groups within a national economy. There is no such clear-cut distinction as the early classical writers chose to suppose. This assumption had unhealthy consequences because it led to one theory for domestic values and to another for international values. Some of the earlier writers, who were handicapped by their failure to use quantitative methods, had difficulty in uniting both sides of the market into a common scheme of price determination. Accordingly, their theory of domestic values stressed cost and supply aspects unduly, whereas their theory of international values overemphasized the demand side. Actually it would have been better for economic theory as a whole to have evolved the same techniques to handle both kinds of markets. This was subsequently accomplished by Ohlin and others. Today it is generally realized that international trade is simply a special case of interregional trade.

The labor theory of value is undoubtedly the weakest part of the classical treatment of international trade. It remains indefensible despite many amendments and elaborations because it would be valid only if there were no scarce natural resources earning rents, if different grades of labor could be reduced to a common denominator because wages for all kinds of work within a country were in proportion to productivity, and if all three factors of production were always *locked up* in fixed proportions in every undertaking. Actually, any one of these three requirements is seldom met; and it simply is not true that prices of domestic goods are equal, or even in proportion, to the total amount of labor they represent. In addition the labor theory of value ignored the role of exchange-rate fluctuations.

It is no longer correct to say that the money supplies of different countries rise and fall in obedience to the dictates of an automatic gold standard. The price-money flow mechanism seldom operates at the present time. Today governments adopt definite fiscal policies, and seek to control these matters through their central banks.

The main body of value and monetary theory has come a long way since Mill. The subsequent ideas of Marshall, Keynes, and Mrs. Rob-

inson, to mention only a few, are all applicable to foreign trade. Modern theories of international economics incorporate these improvements. That the classical theories are now obsolete for some uses is no disparagement of their founders. One expects improvement with the passage of time, and modern writers have had the benefit of their predecessors' ideas.

# **The Machinery of Policy- Making in Washington**

The vast machinery of federal government is complex, and so is that part of the apparatus dealing with foreign economic policy. With so much incorrect information and so many exaggerated views circulating by way of the popular press, television, and political campaigning, international economic policy-making seems to many students to border on the mysterious. It is almost cryptic in a few cases, to be sure. As a general rule, however, the procedures of international economic policy-making simply reflect the complexity of modern government and the ramifications of the policy issues involved.

A short treatment can only attempt to cover the highlights of the subject. We propose first to indicate something about the flow of information from diplomatic missions abroad to the agencies in Washington, and then deal successively with policy-related research efforts in the nation's capital, policy-making at departmental and interdepartmental levels, and finally the role of the White House. We shall say little about the way in which Congress fits into the picture, despite the fact that its role is basic under our system of government, because most congressional operations are widely and responsibly publicized.

## **REPORTS FROM THE FIELD**

Most of the material used in policy-making flows to Washington in the many reports—cables, airletters, and other documents—originating from our embassies, legations, consulates, and special missions abroad. These range all the way from super-secret material to clippings from local newspapers. "Big Name" diplomats are involved in the work that goes into these reports, but as a rule mainly in an indirect or general

supervisory way. A few decades ago such men did much of the reporting. This is no longer the case. The real work incorporated in the cables and reports is done by specialists—economists, agricultural experts, engineering, and military specialists—who consult frequently and usually informally with their counterparts in the host government. In the case of embassies in the most important countries, for example, Great Britain, Russia, Canada, France, Germany, India, and Japan, our staff is likely to be of the very highest quality and regarded with great professional respect alike by technicians in the local government and the most important government people in Washington.

Reports sent to the nation's capital are of two kinds, required and voluntary. Those that are required in turn are of two types—periodic reports on designated subjects, and replies to specific telegraphic or other requests for information in connection with Washington policy planning or other purposes. The periodic reports in the economic area are fairly numerous. They usually cover, for example, monthly reports on such things as import and export trade of the country to which our diplomats are accredited, commodity prices, commercial policies, international payments, money and credit, employment, and agricultural and industrial production. There are also annual reports, often bulky, on foreign trade, foreign investment, the exchanges, balance of payments, trade and payments agreements, production, the federal or national budget, and so forth. The same reports are not required in all countries. Much more information is needed with respect to developments in economically important nations, since developments in them are likely to affect policy-making to a greater degree than comparable developments in small countries.

Little can be said except in broad generalities regarding the required work in connection with specific telegraphic or other requests for information from Washington. Thus, officials in the capital may need information on a particular situation, which they will request the ambassador or minister to furnish, often on a "soonest" basis. Such requests are as a rule received by the ambassador's staff specialist, who then proceeds to do whatever is necessary to obtain the information. In another kind of situation, Washington may not need information as such—in the sense of data and descriptions of events—but the embassy's judgment on a particular matter. Requests of this kind are very important as a rule, since the on-the-spot judgment weighs heavily in decision-making. Not unusually, several persons in the embassy will get together to hammer out a reply to Washington. Checks and balances are also of a formal character. Thus the report—other than from the ambassador himself, though there are exceptions here too—that is

sent to Washington usually states the name of the party who drafted it, the name of the authorizing officer, and the name or initials of one or more superior officers who concur in the findings or submissions.

We turn next to the voluntary reports. It is still more difficult to describe such reports than to indicate the general content of replies to specific requests. They are, however, very numerous and usually of value in policy-making. What they contain will depend upon the nature of local politico-economic developments, the quality of contacts with local sources of information—especially that which is not public property—the judgment, foresight, and analytical ability of the reporting officer, the practical knowledge of the local economy and the leading economic interests therein, and the imaginative use of local information in relation to unfolding policy problems faced by Washington. When policy-makers on the banks of the Potomac are fairly evenly divided on issues that are controversial within the Executive Branch, it is found that a well thought out and documented embassy report makes all the difference in the world as far as the final decision is concerned. Cables between Washington and one or more foreign posts are likely to pass back and forth with some frequency in such situations, until the issue is resolved.

So much for the standard or regular sources of information and on-the-spot judgments and analyses. Information and judgments are also obtained by senior officials who rely partly on their previous foreign experience and occasional field trips to foreign countries, by senators and congressmen who make survey trips abroad, and by prominent private Americans who return to an influential senator or congressman, to top officials of departments, or even to the White House. Political patronage may also enter the picture. Thus, a substantial contributor to the party in office may see the President to air his views, on, say, a foreign project which he believes warrants a loan by a government agency or other action. Sometimes such intervention carries weight.

### WASHINGTON AT THE TECHNICIANS' LEVEL

Once received in Washington, the documents are promptly classified by subject-matter and security categories and distributed to the interested departments and agencies for use by authorized persons therein. The distribution list, which appears vertically on the left-hand margin of the first page, often consists of a string of strange alphabetical combinations that stand for divisions of the State Department or for other agencies. The eye-catching list would appear something like this: "E"



(for the economic area of the State Department), "RA" (for European regional affairs), "JNA" (Japan-North Asian affairs), "L" (legal), "GA" (German affairs), "TREAS" (Treasury Department), "AGRIC" (Agriculture Department), "COM" (Commerce Department), "DEF" (Defense Department), "EXIM" (Export-Import Bank), and so forth. The "action copy" of the report would go to the division of the Department which would be required to coordinate efforts required for making a decision and, if necessary, drafting a reply to our embassy or mission abroad. One or more persons in each division or agency will have something to do with the document, using information in it as data for his own work, conferring with counterparts at the technicians' level in other agencies, and preparing (if necessary) a draft of his division's or agency's internal (division or agency) position on whatever issue happens to be involved.

Once division or agency preliminaries are well under way at the technicians' level, it is customary to hold an inter-agency meeting. One or more of the interested Washington agencies may have prepared and distributed a draft of a proposed position. Such draft or drafts will occupy the attention of the meeting, where it is likely that the different agency positions will be aired. If the matter at issue impinges upon our political relations with another friendly government and favorable action by the United States is believed likely to improve such relations, the State Department in all probability will indicate its desire to have the technicians recommend favorably. If the proposed action involves spending money, the Treasury representative will be likely to look at the matter with a very critical eye, and in all probability will state that his agency—after due consideration—isn't sure of the necessity of spending as much as is contemplated or of spending it in as short a period as is being proposed. Treasury representatives thus come to be known as "inverted Micawbers," ever waiting for something to turn down. The Commerce Department man is likely to put forward ideas that reflect a business point of view, or a view favorable to, say, expanding American exports if such considerations are involved. And so on for the other agencies—such as the Departments of Agriculture, Defense, and Interior, and the Export-Import Bank, the Central Intelligence Agency, and the Bureau of the Budget. Incidentally, the typical inter-agency meeting involving international economic matters is likely to involve participation only of the State, Commerce, Treasury and Defense Departments. The other agencies attend and actively participate in meetings only when the issue includes matters of substance involving their agency.

Inter-agency work at the technicians' level usually seeks to clarify

the question involved, make sure that all pertinent points are incorporated in the thinking that goes around the table, and to reach a reasonable compromise by drawing up a tentative Executive Branch position for the consideration of top-level officers, such as the assistant secretaries or their deputies. The eventual position that is taken goes out over the name of the Secretary of State. Incidentally, since there are hundreds of outgoing messages from the State Department every day, it is clear that only a few of the papers that stem from inter-agency meetings or from internal decisions of the Department ever reach the Secretary directly. In other agencies, the foreign aspect of the agency's work usually occupies a secondary position as far as sheer volume of paper operations is concerned, and hence only a very few foreign-policy documents reach the secretary level directly in the case of such agencies.

There is one thing about inter-agency, or even intra-agency, work that needs to be said with considerable emphasis. On issues that are controversial, say, with respect to nonsecret matters as revealed to the public in our own newspapers, it is almost a certainty that there will be heated arguments among the interested agencies. One or more agencies is likely to take the position that the press indicates to be the unpopular one nationally or regionally. All manner of facts will be marshaled by the proponents of the different viewpoints, and many of the familiar techniques of debating will be used. The power to persuade is no less important in such meetings than it is elsewhere. It goes without saying, however, that the content of the meetings or even the fact that they are being or have been held is not revealed to the public as a rule. Now and then, of course, a favorite reporter will find a point of view "leaked" to him from high levels, or something will be "leaked" from similarly high levels to a senator. When such things occur it is very hard to pinpoint responsibility, but the agencies having the strongest case in terms of facts and analysis generally say privately in such instances that the leaking of the material really was an underhanded way of trying to "persuade" them to accept a position that they would otherwise reject. Clearly, the leaking of highly classified information can greatly harm the national interest. (Incidentally, the "senator" referred to above is usually a man who is not sympathetic with the Administration's position on the issue. In this connection, we may add that key congressional chairmen, such as the Chairman of the Senate Foreign Relations Committee and the Chairman of the House Foreign Affairs Committee, are almost invariably consulted on a confidential basis about controversial policy issues early in their consideration by the Executive Branch.)

From the foregoing, one further thing may be pointed out: an Administration's somewhat unpopular position on an issue does not indicate, as some columnists and vocal opponents among the public invariably assert, that "everybody in Washington" must be crazy, ignorant, or worse. The official release may suggest that Washington speaks with one mind on the issue. But, as already indicated, the backstage thinking usually is anything but unanimous. This is not strange. Informed people outside the government do not usually think as one mind on complex issues; the same must be said about thinking in the very spotlighted city of Washington.

### **POLICY-MAKING AT THE DEPARTMENTAL LEVEL**

The foregoing has minimized the guidance-role of top policy-makers, though that role was explicit in some cases and implicit in other parts of the discussion. We must now broaden our description to deal with activities at this level. Before we do, however, it may be worthwhile to call attention to two considerations. First, issues may be handled simultaneously by both technicians and top policy-making officials. In a sense, this is always the case. It is so in the sense that the technicians work partly with the present shape of similar policy firmly in mind. They inevitably also try to avoid not losing sight of the views and, indeed, the prejudices of their superiors. Such views and prejudices are regularly transmitted by way of, say, the weekly staff meeting at which division or unit heads meet with bureau chiefs and assistant secretaries. In this connection, it is wrong to feel that "the policy line" is laid down rigidly by top policy-makers. No men appreciate the complexity of the issues more thoroughly than truly able top officials. They have learned much the hard way; in other words, hindsight tells them that minority views in some past decisions, because they were based on a different assortment of facts and assumptions, would have given better practical results than the policy actually followed. Hence, they welcome imaginative minds, and lend encouragement to men with a record of good judgment. Many such men work only at the senior technicians' level.

The second consideration is implied in the first. It is that technicians and policy-makers are not divided by a hard-and-fast line. The two groups merge together imperceptibly in most agencies. This is best seen, perhaps, in a typical form of the division of labor within the economic area of the Department of State. Thus, the Department at this writing has a Deputy Undersecretary of State for Economic Affairs;

he in turn has a deputy; and then there are directors and deputy directors of three offices—the Office of International Trade and Resources, the Office of International Financial and Development Affairs, and the Office of Transportation and Communications. Each of the three Offices contains divisions, at the head of which is a chief. He in turn has an assistant chief and a staff. The assistant chief is a technician for all practical purposes; and almost the same may be said of a division chief. The case of a deputy director is not so clear, but it too probably falls more in the technicians' area than in policy-making proper. But the director of an office works so intimately with the (politically appointed) Deputy Undersecretary and his deputy that it would be unduly arbitrary to classify him as a technician.

#### TOP INTER-DEPARTMENTAL COMMITTEES

Policy-making may be illustrated in terms of what are perhaps the two most important international economic decision-making bodies that work at the inter-departmental level. One of these deals with trade matters, the other with financial policies. The former is the Inter-departmental Committee on Trade Agreements (ICTA), which is an agency established by the Executive Branch. The latter is the National Advisory Council on International Monetary and Financial Problems (NAC), established by Congress. The ICTA consists of the Departments of State, Treasury, Defense, Agriculture, Commerce, Labor, Interior, and the Tariff Commission. The NAC, by law, consists of the Secretaries of the Treasury, as Chairmen, and the Secretaries of State and Commerce, the President of the Export-Import Bank and the Chairman of the Board of Governors of the Federal Reserve System.

Both the ICTA and the NAC have supporting staff organizations, though the people in them do not necessarily devote full time solely to Committee business. Thus, the ICTA draws on the commodity and other specialists mainly in the State Department's Office of International Trade and Resources. If necessary, however, it may draw on any individual in the Department. It often draws, for example, on the political desk officers—the men who are in charge of day-to-day work on general diplomatic problems concerning individual countries. The ICTA also draws on specialists in other agencies, such as the commodity specialists in the Department of Commerce. When there are technical customs problems, the Treasury representative on the ICTA sees to it that specialists in his department assist the Committee. Similarly, the Department of Agriculture handles that part of the work

relating to, agriculture, the Interior Department specializes on matters involving domestic minerals or the economic position of our territories, and the Defense Department concentrates on trade aspects that are closely related to national security. There is active participation in all phases of the work by nearly every agency on the Committee, and it is not uncommon for an agency with little professional interest in a given subject to be the stellar performer at Committee sessions. The result is that Executive Branch actions with regard to trade agreements, official international trade organizations, and the like, are based on thorough study, discussion and consultation in which hundreds of specialists are directly and indirectly involved. We may add that this work has declined in relative importance now that resurging protectionism, mainly by way of escape clause actions, has left a greater role to the Tariff Commission.

The NAC functions in the same general way. It is the government's top inter-departmental committee in the field of international finance and the foreign exchanges. Every new loan that the Export-Import Bank proposes to make must be screened and approved by the NAC before the Bank is free to commit the United States Government. The American Executive Director on the World Bank must receive his instructions from the NAC before he can vote for or against a loan action at the Bank. Similarly, the American Executive Director on the International Monetary Fund must get NAC clearance before he can speak in the name of our government. The Department of Agriculture must also come before the NAC if it proposes to sell some farm surpluses abroad in exchange for local currency, or on a long-term loan basis.

The NAC operates on two levels. One consists of the work of its Staff Committee, which is composed of senior staff people in the Treasury, State, and Commerce Departments, and those with the Federal Reserve System and the Export-Import Bank. In addition, other agencies are present at deliberations of the Staff Committee. These usually are the Department of Agriculture, the Bureau of the Budget, and the Council of Economic Advisers.

The job of the Staff Committee is to do the spadework for the NAC. Each case is dealt with as thoroughly as possible, after which a recommendation is prepared and sent to the NAC. This top-level body usually is attended by assistant secretaries, though key division heads may substitute for them from time to time. The relatively minor cases before it are customarily dealt with by accepting the recommendations of the Staff Committee, especially if these have been reached by unanimous vote. On the big issues, however, the Council is likely to debate at length before taking action for or against a proposal.

### • OTHER ACTIVITIES AT THE DEPARTMENTAL LEVEL

Officials in the executive departments concerned with international trade and finance also engage in many other operations in connection with making policy. For instance, they do liaison work with Congress. They brief congressmen and senators, try to answer complaints that constituents ask their congressman to handle, detail a specialist or two to a congressional committee working on a technical trade or financial problem, and so forth. They are also engaged in liaison with international agencies, principally the Organization for European Economic Cooperation, NATO, and the United Nations. Department officials find much to do as well with citizen groups, and particularly with advisory boards and outstanding trade organizations such as the National Foreign Trade Council. All such contacts contribute bits and pieces that are grist for the policy mill.

### THE WHITE HOUSE

We turn finally to the direct role of the President. The White House concerns itself only with central issues and the broadest policy matters. There is plenty of good assistance available to the President among the different units of his own official family—the various offices of the Executive Office of the President. For example, there are the Bureau of the Budget, the Office of Defense Mobilization, and the Council of Economic Advisers. But these agencies are only partly concerned with foreign economic policy or with security policy. For assistance in such fields, the President relies mainly on two agencies. These are the National Security Council,<sup>1</sup> the top agency involved in advising the President about all phases of security policy, and the Council on Foreign Economic Policy, which assists the President in formulating a government position on the tougher issues of foreign economic policy. Both are structured on inter-departmental lines, with the State and Defense Departments probably playing the greatest roles, but each has its own small, specialized staff. In the case of the Council on Foreign Economic Policy, the views of the chairman—who usually is a businessman—usually carry great weight.

The President's actions in the fields of international trade and finance reduce to several key types. First, he makes final decisions re-

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<sup>1</sup> For details, see an authoritative account by Robert Cutler, "The Development of the National Security Council," *Foreign Affairs*, April, 1956.

specting his administration's international trade and finance policies. These consist only partly of formulating policies as such. He also adjudicates conflicts within his own executive family. When the interested parties are unable to agree on the tough problems, the issue always goes to the President for resolution. Second, key trade and finance bills that are to implement the President's policies are cleared with him by responsible party members in Congress. He also directs the strategy that is intended (a) to win broad public acceptance for his policies and (b) to influence a favorable vote in Congress. There is an important final matter. Internationally, the President is the man who speaks for the United States, and the one who receives the most prominent publicity concerning the United States in the foreign press, radio, television, and so forth. It is his job to see to it that the pieces in the jig-saw of world events fall into place in such a way as to strengthen the American position. Thus, he is constantly urged by his advisers to make a statement for this or against that—all intended mainly for foreign consumption.

As far as trade and finance are concerned, actions by the President that are intended primarily for foreign consumption are generally designed to do three things. First, to assure friendly foreigners that we have their true interests at heart whenever the United States takes action that may affect their economy. With respect to trade, this is designed mainly to assure friendly foreigners that the President will use the power of his office to encourage the maximum importation of foreign goods consistent with the security of the United States and/or whatever intractable domestic political situation that may exist. With respect to finance, the principal aim is to assure friendly foreigners that the government will do all in its power to encourage foreign access to the American capital market, to the end that there may be a maximum of sound economic development abroad. Second, the President seeks to strengthen the economic ties that bind us to our allies by taking the initiative in suggesting ways and means by which allied countries can work with the United States to achieve common objectives. Third, the President engages in a variety of actions to weaken foreign forces that are hostile to America's best interests.

More than anything else, the office of the President is a symbol of America—hence the President's critical role in the conduct of our foreign relations. Successful performance depends on having excellent information, sound evaluation and imaginative use of such information by every department and agency of the government, the prestige that the President is able to win for himself in foreign and domestic eyes, and solid support from the citizenry and Congress for his major policies, domestic and foreign.

# INDEX





# Index

## A

Absolute advantage, 303  
 Acceptance, 144  
 Adjustments, national, 82ff., 153  
 Administrative protection, 252ff.  
 Agricultural Adjustment Act, 378-379, 384  
 Agriculture:  
     and GATT, 378  
     and state trading, 435  
     land areas, 52, 63, 462  
     price supports, 371, 384ff.  
     protection of, 340-342, 384ff.  
 Aid, 3-12, 25, 129, 132, 134, 197ff., 407ff., 527ff.  
 Airlift, 292  
 Amtorg, 426  
 Anglo-American loan agreement, 347  
 Annual Review of OEEC, 410ff.  
 Anti Dumping Act of 1921, 233, 384, 399-403  
 Arbitrage, 160-161, 170  
 Argentine beef, 226  
 Atlantic Community, 422  
 Atomic energy, 419

## B

Backward countries, 301, 302, 459ff.  
 Balance of payments:  
     analysis of, 121ff., 136  
     and balance of trade, 122, 129, 350  
     and credits and debits, 41, 138  
     and disequilibrium, 133  
     classification of, 130  
     comparisons of, 132

Balance of payments (*Continued*):  
     current account, 126, 132, 135  
     defined, 121  
     difficulties, 213, 371-373, 382  
     of the United States, 126ff., 347ff.  
 Balance of trade, 87, 122, 350  
 Bank draft, 141  
 Bank for International Settlements, 201  
 Bank of England, 190  
 Benelux, 243, 414, 421  
 Bilateral payments agreements, 179  
 Bilateral quotas, 263  
 Bilateral trade and payments, 21, 197, 209  
 Bill of exchange, 143-145  
 Bill of lading, 144  
 Bindings, 307  
 Birth control, 330  
 Birth rates, 4-6, 8  
 Bounties, 229  
 Britain and the International Wheat Agreement, 450  
 British exchange control, 183ff.  
 Broker, 232  
 Bulk purchase agreements, 436  
 Bureau of the Budget, 595  
 Burmese rice and Soviet trade, 431  
 Business cycle, 339  
 Buy American Act, 228-229  
 Cable transfer, 142  
 Caloric intake, 5, 7  
 Capital market, 512  
 Capital mobility, 79

- Capital movements (*See* Balance of Payments)
- Capital-output ratio, 504-506
- Cargo preference and 50-50, 288, 293
- Cartels, 263
- Central banks, 181, 206ff.
- China, 9, 16, 326
- Classical theory of trade, 569ff.
- Clearing, 201, 217
- Clearing agreements (*See* Bilateral Payments Agreements)
- Climate and specialization, 48ff., 63
- COCOM, 413
- Code of Liberalization of Trade, 204, 206
- Coexistence, 435
- Cold war, 11
- Colombo Plan, 521-524
- Commercial policy of the U.S., 337ff.
- Committee for Economic Development, 528
- Committee for Reciprocity Information, 354
- Commodity agreements, 442ff.
- Commodity Credit Corporation, 385, 434
- Commodity specialization, 55
- Common market:
  - and cartels, 418
  - and Euratom, 419
  - in all European products, 420-422
  - in European coal and steel, 416-419
- Comparative advantage:
  - and NATO, 310
  - and real costs, 37, 303
  - and specialization, 12, 303
  - nature of, 36ff.
- Convertibility of currencies, 193ff., 210, 217, 347
- Copyright, 224
- Correspondent bank, 141, 146
- Costs and protection, 229, 232, 233
- Cotton export subsidies, 390
- Council of Europe, 406
- Council on Foreign Economic Policy, 595
- Cross rates of exchange, 166
- Currency arbitrage, 160
- Customs area, 249
- Customs classification, 225
- Customs Court, 254
- Customs formalities, 222, 229, 231, 252ff.
- Customs union, 27, 243, 382
- Customs valuation, 256
- Death rates, 4-6, 8
- Debtor countries, 130
- Deflation, 556ff.
- Demand, role of in adjustment, 38, 62, 84ff.
- Department of Agriculture, 262, 355
- Depreciation of currency:
  - and prices, 84, 88, 109
  - and stimulus to exports, 45-46, 83, 88, 103, 215
  - and U. S. policy, 216
  - and welfare, 89
- Depression, international spread of, 44, 556ff.
- Detroit Chamber of Commerce on free trade, 236, 246
- Development:
  - and agriculture, 506-509
  - and aid, 527ff.
  - and allocation of capital, 494-497
  - and capital-output ratio, 504-506
  - and Coal and Steel Community, 417
  - and Colombo Plan, 521-524
  - and disguised unemployment, 481
  - and industrialization, 509-513
  - and inflation, 485
  - and investment, 485-488, 517ff.
  - and investment criteria, 494ff.
  - and OEEC, 410
  - and population, 5, 472ff.
  - and private enterprise, 501
  - and protection, 511
  - and savings, 476, 500-504
  - and social marginal productivity, 494-497, 507

Development (*Continued*):

and social overhead capital, 497-  
• • 506

and Soviet central planning, 493,  
509

and supervised credit, 509

and surplus disposal, 389, 531

and taxation, 503, 530

and technical assistance, 519ff.

and terms of trade, 479

and the human factor, 506

and the World Bank, 523

and undermaintenance of capital,  
512

general problem of, 459ff.

misconceptions, 477ff.

reasons for, 464ff.

## Discrimination:

and most-favored-nation clause,  
342ff.

history of, 342ff.

in currency arrangements, 214-216,  
346, 347, 348-350

in European coal and steel, 415

in Soviet foreign trade, 428ff., 438

Disequilibrium, 102ff., 133, 372

Disguised unemployment, 481

Division of labor, 302

Dollar shortage, 227

## Draft:

bank, 141, 146

sight, 141, 144, 153, 156

time, 142, 144, 156

Dumping, 224, 232, 234, 399-403

Economic Cooperation Administration,  
408

Economic development (*See* Develop-  
ment)

Economic growth (*See* Development)

Eisenhower, President, 228

Elasticity of demand, 84ff., 100, 111

Ellsworth, P. T., 479

Embargo, 222-224

Employment and inflation, 216

Employment and protection, 297

Energy per worker, 52

Entry at customs, 254

Equation of international demand,  
578ff.

Equilibrium, 34, 46, 70, 82ff., 555ff.

Escape clause, 225, 232, 357ff., 374,  
384, 391ff.

Euratom, 419

European Coal and Steel Community,  
243, 406, 414ff., 423

European free trade area, 420-422

European Fund, 206

European Monetary Agreement, 205ff.

European Payments Union:

and Bank for International Settle-  
ments, 201

and convertibility, 204-206

and discrimination, 205, 215

and European Fund, 206

and European Monetary Agreement,  
205, 209

and Marshall Plan, 196, 407

and OEEC, 196, 409

and role of central banks, 206-208

and sterling area, 204

and trade liberalization, 204

drawing rights, 198-200

gold and, 202-203

history of, 195-197

nature of, 200

quotas, 201, 209

settlements, 201-203, 206-208

units, 201

European Recovery Program, 197

Exchange control, 22, 96, 106, 112,  
136ff., 168, 172ff., 183ff., 215-

217, 224, 226-228, 305, 347

Exchange rates:

analyzed, 155ff.

and discrimination, 110, 197

and international adjustment, 83ff.,  
197

and national income, 563ff.

and price comparisons, 37-38, 197

and trade patterns, 39, 197, 216

critical, 39, 208

Exchange rates (*Continued*):

- cross, 166, 169-170, 197, 208
- equilibrium, 158-159, 216
- forward, 162, 170
- multiple, 175, 210ff.
- official, 208
- spot, 162, 208
- structure of, 156

## Exchange stabilization funds, 97, 166-167, 170

## Excise tax, 252

## Export-Import Bank, 530, 540, 542-544

## Export patterns, 14-15, 338

## Exports per capita, 13

## Factor endowment, 10-13, 63, 73

## Factor movements and trade, 65ff.

## Factor proportions, 51ff., 56, 71

## Famine relief, 387

## Farm surplus disposal, 531-532

## Fiscal policy, 104, 485

## Food and Agriculture Organization, 531

Foreign aid (*See* Aid)

## Foreign exchange transactions, 140ff.

## Free list, 224-225

## Free trade, 73, 236, 246, 420

## Free-trade zones, 248-249, 269

## Frisch, R., 347

## Full employment and disequilibrium, 104ff., 109

## Gains from trade, 36ff.

## General Agreement on Tariffs and Trade:

- and contracting parties, 368
- and customs unions, 375
- and economic development, 374
- and the International Trade Organization, 366
- and Japan, 376, 380
- and most-favored-nation clause, 369
- and Organization for Trade Co-operation, 368, 375-377

General Agreement on Tariffs and Trade (*Continued*):

- and preferences, 369
- and quotas, 371, 374, 380
- and reciprocal trade agreements, 367
- and state trade, 438
- and subsidies, 373
- and tariff reduction, 361
- and waivers, 378-379
- articles of, 369ff.
- described, 366ff.

## Gold points, 165

## Gold standard, 93ff., 100, 164, 170, 187

## Gold "sterilization," 95

## Government purchasing, 228

## Gross national product by countries, 10

## Hamilton, Alexander, 299, 339-340

## Housing, 7

## Hume, David, 572-573

## I

## Immigration, 4, 11, 58, 75, 225, 312ff.

## Immigration and economic development, 319ff.

## Immigration policy of the U. S., 323ff.

## Import licensing, 173, 175

## Import patterns, 14-15, 23

## Imports per capita, 13, 22, 525

## Import propensity, 92

## Incidence of tariffs and quotas, 264ff.

## Income and adjustment, 92

## Inconvertible currency, 157, 347

## India, 329, 532

## India's five-year plan, 493

## Indirect protection, 253

## Induced economic growth, 492ff.

## Infant industry, 299ff.

## Infant mortality, 4, 6

## Inflation, 100, 108, 116, 216, 218

## Injection, 98, 296, 556ff.

## Injury, 233, 391ff.

## Interest rates and adjustment, 96ff.

**International Bank for Reconstruction  
and Development:**

- and development, 518ff., 530
- and International Finance Corporation, 540
- and National Advisory Council, 534
- and private capital market, 536
- described, 532ff.
- end-use supervision, 538
- voting, 534

**International commodity agreements,  
442ff.**

**International Finance Corporation, 540-  
542**

**International investment:**

- and national income, 99
- and the problem of repayment, 548-  
549
- direct, 24, 41
- international differences in, 52-53
- portfolio, 24, 41, 517ff.
- private, 25, 517ff.
- problems of, 544ff.

**International Monetary Fund:**

- and consultations, 213
- and GATT, 215, 372-373
- criticism of, 215
- described, 210ff.
- exchange restrictions, 211, 218
- organization, 211
- quotas, 212
- scarce currencies, 214
- standby arrangements, 213

**International Trade Organization, 366-  
368**

**International Wheat Agreement, 443ff.**

**Interregional trade, 28**

**Investment:**

- and capital markets, 512-513
- equity, 512
- portfolio, 512, 519

**Isolation price, 39, 48**

**Italian emigration, 316-319**

**Keynes, J. M., 490**

**Labor:**

- and capital, 9, 11
- and land, 9, 11, 71
- and shipping, 271ff.
- distribution of, 56, 67
- migration, 74
- productivity and protection, 352

**Labor unions and trade restrictions,  
234**

**Land, 52, 54, 66, 71, 79**

**Leakage, 98, 106, 296, 556ff.**

**Lend-lease, 407**

**Liberalization of European trade, 204**

**Licensing of imports, 262, 266**

**Liquidation at customs, 254**

**List, Frederick, 299**

**Local currencies, 235, 387ff.**

**Location of industry, 58ff.**

**M**

**Marks of origin, 230**

**Marshall Plan, 407-409, 529**

**Marx, K., 490, 502**

**McCarran-Walter Act, 325ff.**

**Mercantilism, 289, 569ff.**

**Merchant Marine Act of 1936, 283,  
285**

**Merchant marine fleets of the world,  
275**

**Migration, 316**

**Mill, J. S., 578ff.**

**Minimum wage, 301, 304**

**Mint parity, 164**

**Mixing quotas, 264**

**Mobility of resources, 79**

**Monetary policy, 96**

**Monopoly, 426-428, 435-439**

**Monopsony, 267, 429**

**Mortality rates, 4**

**Japan and the GATT, 376, 380**

Most-favored-nation clause:  
 and Japan, 380  
 conditional, 343-344  
 history of, 342ff.  
 in trade agreements, 353ff.  
 unconditional, 343, 345  
 Multilateral payments system, 209,  
 211, 216  
 Multiplier, 97ff., 555ff.

## N

National Advisory Council, 534, 543,  
 593-594  
 National defense and tariffs and quotas,  
 308ff., 363  
 National income:  
 and protection, 296  
 equilibrium level of, 98, 296, 557ff.  
 Nationalization, 503  
 National Security Council, 595  
 Natural resources, 22, 465, 466  
 Network of world trade, 17  
 North Atlantic Treaty Organization,  
 20, 291, 310, 312, 406, 411,  
 595  
 Nurkse, R., 480  
  
 Office of Defense Mobilization, 363,  
 595  
 Opportunity cost, 113-115  
 Optimum population, 312, 329ff.  
 Organization for European Economic  
 Cooperation, 196, 406ff., 595  
 Organization of American States, 521-  
 522  
 Organization for Trade Cooperation,  
 368, 375-377  
 Overpopulation, 21, 461  
 Overvaluation of currencies, 185

Panama Canal, 274, 291  
 Parity, 385  
 Patents, 230

Payments agreements, 178-182, 197,  
 413  
 Per capita trade, 525  
 Peril point, 358  
 Petroleum, 236, 308  
 Point Four Program, 508, 521-522  
 Policy making in Washington, 587ff.  
 Population growth, 5, 312ff.  
 Population patterns, 5, 6, 13, 52, 56,  
 312ff., 461  
 Population pressure, 4-8, 10, 312ff.,  
 329-330, 461  
 Preferences, 369, 421  
 President, and economic policy, 595-  
 596  
 Price supports in agriculture, 371,  
 385ff., 435, 447ff.  
 Productivity in agriculture, 332  
 Protection, 223ff., 253, 295ff., 308, 311,  
 352, 391ff., 569ff.  
 Protection in the South, 236, 340  
 Public Law 480, 387ff., 447, 454  
 Purchasing power parity, 159  
  
 Quantitative restrictions, 225, 259ff.,  
 371ff., 380  
 Quotas, 224ff., 249ff., 259ff., 264,  
 326, 347, 363, 371ff., 381  
  
 Rate of Exchange (See Exchange rates)  
 Reciprocal trade agreements, 223, 235,  
 353ff., 397, 593  
 Regionalism in Europe, 405ff.  
 Rent, 67, 76  
 Resources and trade, 51ff.  
 Retaliation, 267, 349  
 Ricardo, David, 576ff.  
 Robinson-Patman Act, 401  
 Ruble, 432, 440  
  
 Savings and economic growth, 500-  
 504

- Self-sufficiency, 27, 311
- Senior, Nassau, 581
- Shipping, 13, 226, 229, 271ff.
- Shipping and national defense, 282, 289ff.
- Shortage of dollars, 21-24, 227
- Sight draft, 141
- Smith, Adam, 224, 573ff.
- Smuggling, 250
- Social marginal productivity, 494-496, 507
- Social overhead capital, 497-506
- Soviet-American relations, 290, 308, 413, 526
- Soviet bloc, 4, 16, 138, 426
- Soviet planning, 426, 489, 493
- Specialization and trade, 4, 20, 48ff., 55, 57, 60, 73ff., 308ff.
- Special United Nations Fund for Economic Development, 527
- Spontaneous economic growth, 490ff.
- State trading:
  - American, 434
  - and trade barriers, 437-438
  - European, 433-434
  - Soviet, 425ff.
- Sterling area:
  - and convertibility, 195
  - and European Payments Union, 194
  - and exchange control, 190ff., 217
  - and sterling accounts, 193
  - described, 187ff.
  - freedom of transfer internally, 192-194, 217
  - wartime, 190
- Sterling exchange:
  - American account, 184, 194
  - and sterling accounts, 183-185
  - nonresident, 194
  - rates, 191
  - resident account, 184
  - transferable, 184, 432
- Strategic materials, 387, 413
- Structural changes, 81ff.
- Subsidies, 224, 229, 271ff., 373, 390
- Suez Canal, 274, 276
- Sugar quotas, 262
- Supervised credit, 509
- Supranationalism, 414ff.
- Surplus disposal, 387ff., 450, 452, 531
- Swing credit, 181
- Synthetic products, 19, 50, 229
- Tankers, 279
- Tariff Act of 1930, 226, 255, 342
- Tariff classification, 232, 345-346
- Tariff Commission, 234, 253, 259, 357ff., 392-398
- Tariff rebates, 249
- Tariff quota, 259
- Tariffs:
  - ad valorem*, 224, 231, 250, 356, 381
  - and costs, 306
  - and escape clause, 391ff.
  - and labor unions, 234
  - and national defense, 308ff.
  - and politics, 25-26, 304, 307
  - economics of, 249ff.
  - history of in the United States, 339-342
  - rates of, 224, 249ff., 306
  - revenue, 225, 251
  - specific, 224, 250
- Taxation and development, 530
- Technical assistance, 519ff.
- Technology:
  - and development, 519ff.
  - and new products, 50
  - and population, 5, 25
  - and trade, 50, 63
- Terms of trade, 44ff., 56, 89, 267, 436, 479
- Tied loans, 542-544
- Totalitarian trade methods, 428ff.
- Trade Agreements Act, 223, 353ff., 397
- Trade balances, 17-18, 91, 93
- Trade-mark laws, 230
- Trade patterns, 14-16, 18, 338
- Trade per capita, 525



Tramp ships, 274  
 Transferable currencies, 182  
 Transferable sterling, 184, 432  
 Transportation costs, 34, 40, 57ff., 65,  
     74  
 Treasury Department and customs, 253  
 Triangular trade, 77  
 Tripartite Monetary Agreement, 210

## U

Underdeveloped countries (*See also*  
     Development):  
     and aid, 24, 527  
     and population pressure, 11, 301,  
     461  
     performance of, 461ff.  
 Underemployment, 21, 481-482  
 Unemployment, 303, 321, 351, 481  
 Unions and immigration, 331  
 United Nations, 522  
 United States trade policy, 337ff.

Valuation of imports, 224, 231, 256-  
     259  
 Variable proportions, 67  
 Venezuelan oil, 19  
 Viner, J., 399

## W

Wages and protection, 352, 439  
 Waivers under the GATT, 378  
 War and shipping, 272ff.  
 Washington policy-making, 587ff.  
 Watches, 308, 364  
 Western European Union, 406  
 Wetbacks, 314  
 Wheat agreement, 443ff.  
 Wheat prices, 445  
 Wool, 29, 229, 244  
 World Bank (*See* International Bank  
     for Reconstruction and Develop-  
     ment)

